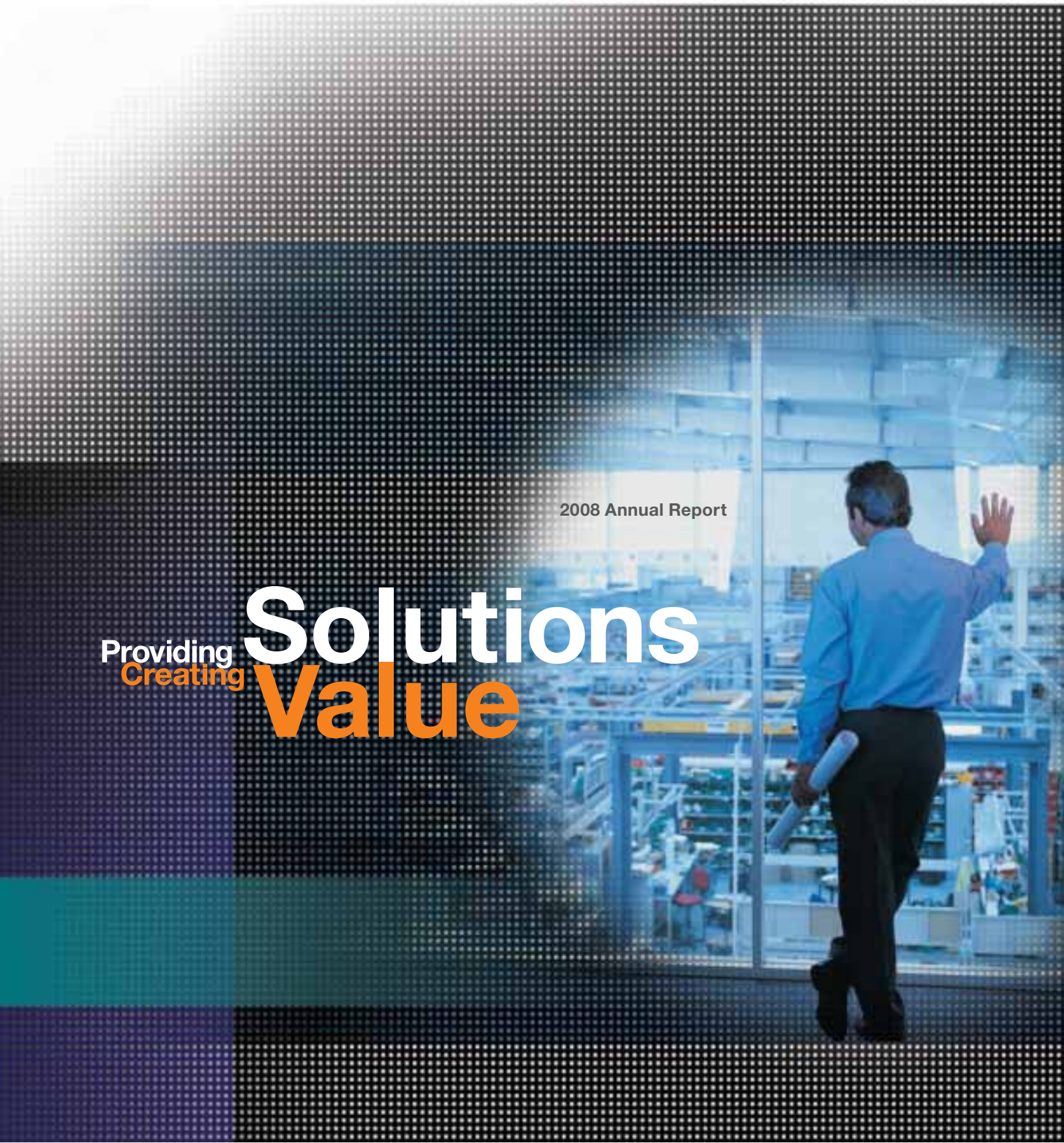


2008 Annual Report

Providing  
Creating

# Solutions Value





# Applied® Providing Solutions, Creating Value

Applied Industrial Technologies is one of North America's largest independent industrial distributors with more than 3 million parts critical to the manufacturing and maintenance operations of businesses in virtually every industry segment. We are a vital link between suppliers and customers, providing value-added services for both groups.

Our people make a difference and provide us with unique advantages that other distributors cannot offer. We use our knowledge and expertise to better understand our customers' businesses, and we help them find ways to manage their operations more effectively. We are redefining the role of customer service by providing solutions and creating value for our customers and suppliers, which in turn create gains for our associates and shareholders.

This report contains statements that are forward-looking, as that term is defined by the Securities and Exchange Commission in its rules, regulations and releases. Applied intends that such forward-looking statements be subject to the safe harbors created thereby. All forward-looking statements are based on current expectations regarding important risk factors, including those identified on pages 14 and 15 of this report and in our Annual Report on Form 10-K for the fiscal year ended June 30, 2008. Accordingly, actual results may differ materially from those expressed in the forward-looking statements, and the making of such statements should not be regarded as a representation by Applied or any other person that results expressed therein will be achieved.

## Applied At A Glance

Applied Industrial Technologies serves Maintenance Repair Operations (MRO), Original Equipment Manufacturing (OEM), and Government markets with a diverse range of quality products, including bearings, power transmission components, fluid power components and systems, industrial rubber products, linear components, tools, safety products, and general maintenance and mill supply products. We also provide customized mechanical, fabricated rubber and fluid power shop services, as well as services to meet storeroom management and maintenance training needs.

**Headquarters:**

Cleveland, Ohio, USA

**Operating Facilities:**

459 in 48 U.S. states,  
5 Canadian provinces,  
Puerto Rico and  
13 Mexican states

**E-Commerce:**

[www.applied.com](http://www.applied.com)

**Distribution Centers:**

7

**Stock Keeping Units (SKUs)****Available to Customers:**

More than 3 million

**Customer Accounts:**

More than 156,000

**Product Manufacturers:**

More than 2,000

**Stock Ticker Symbol:**

AIT is listed on the  
New York Stock Exchange

**Employee Associates:**

4,831

**ABOUT THE COVER**

Today's plant managers are continuously looking for new solutions to improve the efficiency of their operations. Applied is focused on **Providing Solutions and Creating Value.**

+quality



# 2008 Financial Highlights

(In millions except per share amounts, shareholder and employment figures)

Year Ended June 30,	2008	2007	2006
Net Sales	\$ 2,089.5	\$ 2,014.1	\$ 1,900.8
Income Before Income Taxes	\$ 151.7	\$ 133.8	\$ 113.1
Net Income	\$ 95.5	\$ 86.0	\$ 72.3
Net Income Per Share	\$ 2.19	\$ 1.93	\$ 1.57
Number of Shareholders at June 30*	6,305	6,242	6,192
Average Common Shares Outstanding	43.6	44.5	46.2
Cash Dividends Per Share	\$ 0.60	\$ 0.48	\$ 0.40
Number of Employees at June 30	4,831	4,649	4,684
Return on Equity	20.0%	19.9%	17.9%
Cash Provided From Operations	\$ 110.3	\$ 70.9	\$ 69.9

\* Includes employee shareholders in the Applied Industrial Technologies Retirement Savings Plan.

## FISCAL YEAR 2008 BUSINESS/OPERATIONAL HIGHLIGHTS

### GROWTH

Applied Industrial Technologies achieved record sales in fiscal 2008 of \$2.1 billion. Net sales increased 3.7% over fiscal 2007 and earnings per share increased 13.5% to \$2.19. Operating income improved to \$152.8 million, a 13.2% improvement over last year, while operating margin improved to 7.3%, compared to 6.7% last year. Selling, distribution and administrative expenses decreased to 19.9% of sales from 20.5% last year.

### STOCK REPURCHASES AND DIVIDENDS

During fiscal 2008, Applied purchased 1,144,900 shares of the company's common stock on the open market. Quarterly dividends for fiscal 2008 totaled \$25.7 million or \$0.60 per share, a 25% increase over last year. The company has increased its quarterly dividend 181% over the last four years.

### ACQUISITIONS

Strengthening its position in the Mexican markets, Applied acquired Suministros Industriales Enol, S.A. de C.V. (Enol) and its group of companies. Headquartered in Puebla with 10 service center locations, Enol distributes power transmission products, bearings, hydraulic hose, electric motors, conveyor products and lubricants.

Applied also acquired VYCMEX S.A. de C.V. (VYCMEX) and its group of companies headquartered in Monterrey, Mexico. VYCMEX is the region's largest independent fluid power distributor, serving the manufacturing, mining and metal processing industries with expertise and capabilities in fluid power products and systems.

### SUPPLIER AGREEMENTS

Effective in August 2008, the company became an authorized distributor for NSK Corporation, further broadening Applied's offering of bearing products. In fiscal 2008, the company formally launched the Sumitomo Drive Technologies product line and entered into new supplier agreements with Dixon Sanitary, a supplier of stainless steel sanitary fittings and valves, and DeWALT Industrial Tool Company, a leading manufacturer of industrial power tools and accessories.

### HONORS

Applied received numerous customer and supplier awards for its operational strengths, including outstanding customer service, technical support, and overall value added.

*Forbes* magazine again selected Applied to its Platinum 400 List of The Best Big Companies in America. This is the fifth consecutive year Applied has made the list and is ranked within the top 100 this year. *Forbes'* selection criteria include five-year profitability and growth, sales and earnings performance, accounting and governance practices, and financial condition.

Applied continues to climb the ranks of the prestigious *InformationWeek 500* list of U.S. companies using information technology (IT) in an innovative manner. For 2007, Applied ranked number 21 out of 500 firms, up from number 26 last year, for its innovative use of information technology systems for customer service, its business-to-business web site, as well as internal IT systems for employee effectiveness and efficiency. The company has been on this list annually since 2000 and within the Top 100 four times.

### TECHNOLOGY

Applied continues to invest in technology systems that improve its operating efficiencies and add value to customer interactions. In fiscal 2008, Applied further developed ASYST, a web-based, user-friendly interface for internal associates. Going forward, we expect ASYST will help us to continue to reduce transaction cycle time and improve customer service and associate productivity.



## Letter to our Shareholders

David L. Pugh, Benjamin J. Mondics

### DEAR SHAREHOLDER:

We are pleased to report that fiscal 2008 was another record year for Applied Industrial Technologies. Our focus on profitable sales growth has yielded our sixth consecutive year of record sales and earnings. Although the economy did soften in the second half of the year, our active management of inventory and other assets, productivity improvements, and implementation of cost controls produced financial results of which we are proud.

Net sales in fiscal 2008 rose 3.7% to \$2,089,456,000, while earnings per share rose to \$2.19, which represents a 13.5% improvement over last year. Overall net income improved 11.0% to \$95.5 million. Despite pricing pressures, our focus on operating margins was successful as they increased to 7.3%. Our investments in information technology systems and corporate-wide employee training programs have boosted the efficiency of our day-to-day operations, while also improving the level of service we deliver to our customers.

Our selling, distribution and administrative expenses were reduced to 19.9% of sales, an historical low, reflecting the productivity improvements we've been developing. Our cash generation from operations also set a record at \$110 million, providing us with a healthy cash balance of \$101.8 million and working capital of \$409.2 million at year end. Our debt-to-equity ratio was 5% and the current ratio (current assets to current liabilities) was 3:1. As a result of our strong financial position, we paid cash dividends of \$0.60 per share during the year, which equates to a current yield of 2.4%. Our cash flow positions us well to invest in continued growth of the business.

### PROVIDING SOLUTIONS AND CREATING VALUE

Our strength in providing solutions and technical expertise is unique and allows us to focus on creating value for our customers. We help customers improve the efficiency of their operations because we have vast product solutions and we understand the technical aspects of energy efficiency, preventative maintenance, parts replacement

strategies, inventory management and training. By bringing these solutions to our customers, we build loyalty and increase sales, which yields greater shareholder value.

Our growth in sales to the government sectors and in fluid power systems is reflective of the efforts we are putting into these target markets because they offer profitable



growth potential. Our full-service approach to fluid power distribution provides system design, product solutions, and repair services, and has proven to be an effective differentiator that also builds customer loyalty and increased sales.

We have continued to make significant investments in our government business. In fiscal 2008, sales in this segment continued to grow at double-digit rates to more than \$72 million. Our status as a Government Services Administration (GSA) contract holder has helped us win significant business for our core products. We have added government industry managers and expanded our focus on federal, state and local government opportunities along with government contractors/agencies. Our large inside and outside sales force gives us the ability to reach a broad range of government organizations, including the armed forces, Army Corps of Engineers, Coast Guard, FEMA, Homeland Security, local police, fire and rescue, and many other government agencies. We have also enhanced our e-commerce capabilities dedicated to GSA and DOD Email contracts, which is having a positive impact on growing our online business.

**ACQUISITIONS**

Geographically, we continue to capitalize on market opportunities in North America with two significant acquisitions in fiscal 2008. Applied purchased the Enol and VYCMEX companies located in Mexico and expects these businesses to prosper as we integrate them with our current Mexican operations. Sales grew 18% in Mexico in fiscal 2008.

Consistent with our strategy to pursue acquisitions that are aligned with our geographic and product needs, and offer a good return to our shareholders, we expect additional acquisitions in fiscal 2009. Already into this new year, we plan to finalize the acquisition of Fluid Power Resource, LLC and seven of its fluid power distribution businesses. These businesses had sales totaling approximately \$244 million in calendar 2007. We believe that, following the purchase, Applied will be North America’s largest distributor of fluid power products.

Looking further into fiscal 2009 and beyond, we expect to remain active in acquiring fluid power distributors in North America as we expand further with this product category.

**ACTIONS TO CREATE SHAREHOLDER VALUE**

First and foremost, we focus on delivering value to our customers because we know that translates into more profitable sales and, ultimately, enhanced shareholder value. Our experienced management team is knowledgeable

about the industrial distribution business and we communicate clearly to our associates, talk frequently with our suppliers to understand their objectives, and spend time with our customers understanding their needs.

During fiscal 2008, Applied repurchased 1,144,900 shares of its common stock for \$33.2 million. At June 30, 2008, we had remaining authorization to repurchase an additional 1,065,100 shares. In keeping with our strategy to return value to our shareholders, we paid dividends totaling \$25.7 million in fiscal 2008.

**GROWING OUR BUSINESS**

We achieved considerable success in fiscal 2008 but we recognize the need for continuous improvement if we are to achieve our goals for fiscal 2009. The economic climate may present new challenges, but we believe our focus on profitable sales growth, margin enhancement, cost control, asset management and hard work will allow us to build on our growth of the past. We thank our employee-associates for their dedication and commitment to our goals; we thank our loyal customers and suppliers for their support; and we thank you, our shareholders, for your confidence in our team. We look forward to another successful year in fiscal 2009.

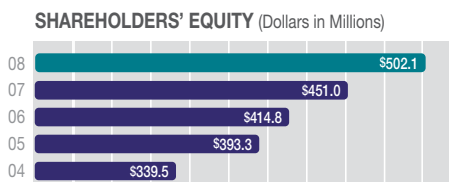
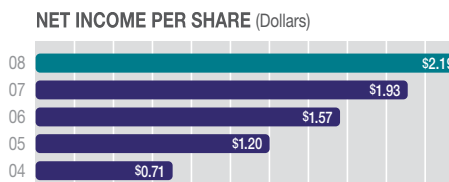
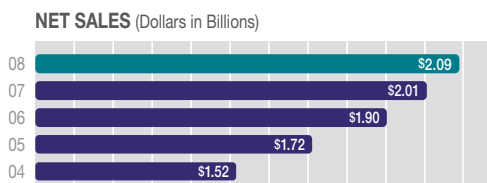
*David L. Pugh*

**David L. Pugh**  
Chairman &  
Chief Executive Officer

*Benjamin J. Mondics*

**Benjamin J. Mondics**  
President &  
Chief Operating Officer

August 15, 2008



# Our Focus on Solutions

Quality Products and Exceptional Service Drive Value

Applied Industrial Technologies is one of North America's largest distributors of industrial parts and components. We deliver the products, technology and expertise that help our customers run their facilities more efficiently. We are focused on delivering solutions that add value and build customer loyalty. This solution-based selling allows us to manage our business for profitable growth, where customers come to us for advanced levels of expertise.

Customer Service drives Customer Satisfaction, which drives Customer Success, and therefore drives Shareholder Value.

Customer  
Service



Customer  
Satisfaction



Customer  
Success



Shareholder  
Value

Applied is an authorized distributor for more than 2,000 high-quality manufacturers, offering more than 3 million products. When a customer needs a part fast, we can deliver. And, we have the technical expertise to make sure the part they get will deliver maximum life, performance and energy efficiency. Our associates are trained in problem solving and work to achieve the highest levels of customer satisfaction. We support our people with superior infrastructure, continuous training, and information technology systems that make them more efficient in their jobs.

Applied has more than 400 locally-managed service centers throughout North America. These centers stock

parts that will meet the most common needs of local businesses with same day or next day availability. Seven distribution centers across North America provide overnight product delivery to our service centers and can get most parts to any customer the next day if necessary.

**Providing Solutions and Creating Value** are the differentiators that make Applied the best at what we do. This business strategy has helped us achieve consistent sales and earnings growth, and profitable returns on investment, for our associates and our shareholders. We support customers in a very diverse group of industries so we are better able to manage growth across multiple sectors of the economy.

We recognize the importance of evolving the business to meet emerging market needs, to introduce new products, and to use technology to reduce expenses. We are continuing to expand our fluid power and government sales activity where solution selling is an advantage. We are expanding our product lines with a growing number of green and sustainable products. And, we are investing in information technology solutions that are streamlining our internal operations and expanding our external offerings.



+expertise

# Our Focus on People

We Hire Great People and Motivate Them to Excel

Ingrained in the culture of our company is a respect for and dedication to the people we serve and work with. Whether they are customers, suppliers, associates or shareholders, we realize this is a team effort that requires the best people, skills and results. Associates are trained and motivated to achieve stretch goals that help them personally and professionally. Managers are encouraged to use their knowledge and skills to create new opportunities to manage the business for profitable growth. We expect our people to produce extraordinary results, and they do.

We realize that different parts of the country serve different types of manufacturing industries and we provide each service center with the support and tools they need to do their jobs efficiently, while giving them the flexibility to meet the needs of their unique sales and service area. In some parts of the country we have primary metals manufacturing expertise, while other locales may have more experience with paper mills or metal fabrication. We employ product and industry specialists to meet the needs of a specific market so we can add value to our customers in that area.

Our associates undergo extensive professional training each and every year. Our investment in online e-learning has made it easier and more effective for our associates to average more than 40 hours of training annually. Whether it is technical knowledge or management training, associates are required to study, train and advance their individual skills in order to make themselves and our company more valuable. We recognize it is knowledge and expertise that position us ahead of our competition. We are investing in our people because they are **Providing Solutions and Creating Value.**

Applied has received numerous awards as a result of our ability to attract, develop and retain highly skilled associates, while creating a culture that makes Applied a great place to work. We clearly communicate our expectations, we measure our results, and we make continuous adjustments to improve our performance.





# Our Focus on Productivity

## Pursuing Operational Excellence in All We Do

Managing our business for profitable growth requires us to focus constantly on productivity improvements. Training our people is just one piece of our commitment to being the best at what we do. Our investment in the infrastructure that supports our business is also critical to our success. Information technology, inventory management, and distribution systems are forefront in our strategy to improve the efficiency of our operations.

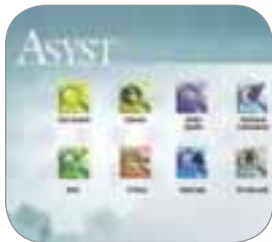
In fiscal 2008, Applied further developed a proprietary user interface called ASYST. ASYST will enhance our order entry system and make product information available instantly and accurately throughout our U.S. service center network. This easy-to-use interface will help service centers manage inventories, order products, manage customer accounts, access product specifications, and much more. From a single screen, our inside sales staff will be able to instantly access all the information they need to quickly process an order or quotation.

This new interface also includes proprietary cross-selling and upselling tools that will help customers get all the products they need to complete the job. Product cross reference guides, quick reference sheets, and sales scripting documents will quickly identify companion products. The result will be more productive employees and more satisfied customers. With more than 3 million products to manage, we are committed to providing our customers with the most accurate product information and the fastest product delivery. ASYST helps us provide operational excellence in our customer transactions.

**Providing Solutions and Creating Value** means customers can interact with Applied through our approximately 1,500 inside sales and 1,000 outside sales staff. Or, they can order through our online catalog at [www.applied.com](http://www.applied.com) or by using our traditional printed catalog. Each of these important sales channels is designed to support our customers with the level of service they need to meet their unique requirements.

The new ASYST program has several productivity enhancements including:

- improved order processing
- expanded search capabilities
- account status validation
- stock location and availability status
- additional technical information
- email part and order search results
- optimized shipping tools

A woman with dark hair, wearing a headset and glasses, is shown from the side, working at a computer. She is looking at a laptop screen which displays a software interface. Her hands are on the keyboard. The background is a blurred office setting. A large, stylized graphic of a plus sign followed by the word "efficiency" in a bold, sans-serif font is overlaid on the bottom right corner of the page. The plus sign is white and the word "efficiency" is in a light blue color.

+efficiency



## Our Focus on Creating Value

Our Documented Value Added® Programs Have Tracked Billions of Dollars Saved



Applied associates are constantly looking for ways to create value for the organization. When we create value in our jobs, we create value for our customers, our suppliers, our shareholders and ourselves. We have been successful offering our customers energy-efficiency programs that allow us to analyze their business operations and make product recommendations that will reduce their energy usage and minimize energy costs. New, high-efficiency motors, drives and power transmission components can significantly reduce energy consumption. Applied account managers are trained to be experts in evaluating plant operations and recommending solutions that save our customers money or improve productivity.

In addition, Applied offers world-class supply chain management systems that can support our customers with on-site and off-site inventory. We have replacement part strategies that advise customers on when it is more cost-effective to replace a part than to repair a part, based on new energy-efficiency improvements and expected product life.

Downtime can cost an organization thousands of dollars per minute, and Applied is proactive about helping customers manage their service needs to reduce downtime. We also understand the needs of many businesses

and we know how to manage our own inventory to provide same day delivery when necessary. All of our service centers offer 24-hour emergency service, seven days a week, and customers know they can call on us whenever they need our assistance.

Applied is a leader in offering our customers a Documented Value Added® (DVA®) program where our associates monitor and report value-added services on a monthly, quarterly, semi-annual or annual basis. Beyond product cost, we track many underlying costs that can be minimized to increase a facility's profitability. We calculate savings from improved product life, reduced maintenance and labor costs, reduced energy consumption, reduced inventory investment, and other transactional savings.

In one example, a manufacturer's production line came to a halt because a unique bearing assembly failed and the replacement parts were not available. The Applied associate used his knowledge to modify a standard bearing assembly that was in stock and saved the company 12 days of downtime, plus significant transportation and labor costs, totaling more than \$2 million. In another case, Applied saw that a large manufacturing operation was investing a lot of time and expense in relubricating bearings on a cooling conveyor. Our recommendation to replace those bearings with composite bearings that require no relubrication saved the company \$155,000 per year at one plant and is being implemented at two additional plants.

Many customers have goals to reduce costs within their organization and our DVA programs are **Providing Solutions and Creating Value.**

# Our Focus on Growth & Acquisition

## Building On Our Strengths

Applied will continue to focus on its core businesses in North America as our best opportunities for growth. We have core competencies in providing sales and service support for a wide range of industrial supplies that include bearings, power transmission components, fluid power components and systems, industrial rubber products, linear components, tools, safety products, general maintenance and a variety of mill supply products.

Our government sales have experienced double-digit growth the past few years and are forecast to continue at this rate. This business has allowed us to expand into new federal markets with our core products, while also allowing us to introduce new products to a very broad and diverse market of state and local government facilities.

Federal and defense spending is expected to be strong for the next several years. The federal government has many buildings and vehicles that are targeted for refurbishment, while the Air Force has a "Refresh and Reset" program that will provide growth opportunities.

Applied is an authorized GSA contract holder and offers procurement and logistic services that meet the needs of many government contract purchase agreements. We have added government industry managers in many of our regional offices to increase our proactive sales efforts for this market. We are also training our service center staff to be supportive of the unique requirements for government business opportunities. Our technical service expertise is a key advantage and differentiator for our business in this market.

### New products introduced as a result of government business opportunities include:



PowerFlare®

- PowerFlare® – tough, durable LED flares used by police, fire and EMS agencies
- BioRem 2000 – biodegradable cleaner that neutralizes chemical spills
- Makita sparkless drill – for hazardous environments
- Emergency Preparedness Products
- Tools and Toolkits

The fluid power business continues to be a strong part of our growth strategy as we pursue acquisitions for geographic penetration, as well as new suppliers for an expanded line of products and services. Our technical expertise in system design and integration has become a solid opportunity to grow the business with a stronger presence in hydraulic, pneumatic, and fluid filtration applications.

With the planned acquisition of Fluid Power Resource, LLC (fiscal 2009), Applied will have 67 sales and service facilities across North America dedicated to providing fluid power products and services. Applied's strong track record of fluid power sales, aided by acquisitions and effective management, will result in this product category representing approximately 25% of total net sales in fiscal 2009.

Our steady growth in this market will allow us to expand our services to include additional capabilities for fluid power system integration, manifold design, machining, assembly, and repair shop services in many locations, giving us unique advantages for **Providing Solutions and Creating Value.**





# Our Focus on Shareholder Value

## Superior 5-Year Growth

A \$100 investment in Applied shares at the close of business on June 30, 2003 was worth \$282 on June 30, 2008. This cumulative total return is significantly better than industry average returns for the same period and is a result of our focus on the four cornerstones of our strategy:

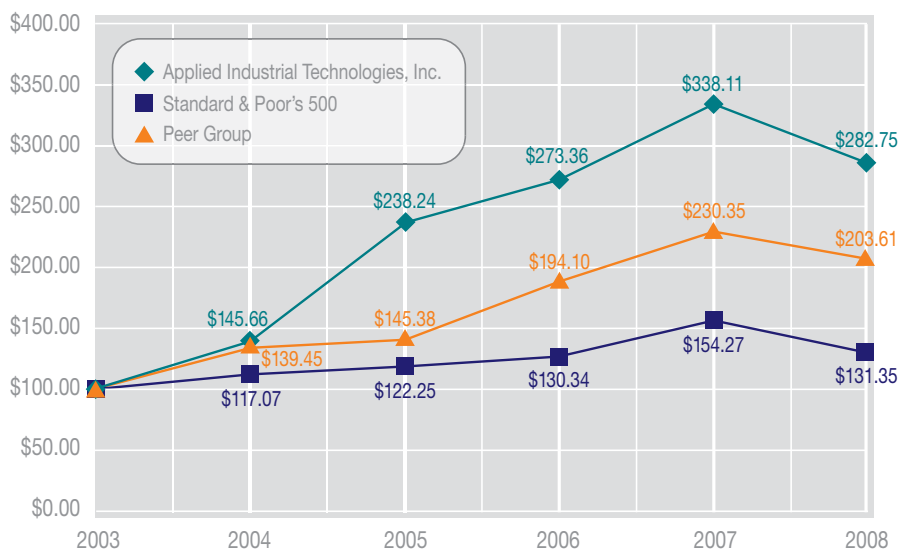
- Profitable Sales Growth
- Margin Enhancement
- Cost Control
- Asset Management

We continue to manage the business for growth and a profitable return on investments. Our strategy of focusing on value-based solutions for our customers is the foundation of our business. We manage our investment opportunities to yield increased sales and productivity improvements that boost shareholder value. We have significantly outperformed our peers over this 5-year period.

We continue to return profit to our shareholders through our dividends, and we repurchase shares when appropriate to support our investments. Officers, directors and associates all share in the risks and rewards of our business. It is our commitment to continue our focus on shareholder value.

### COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN

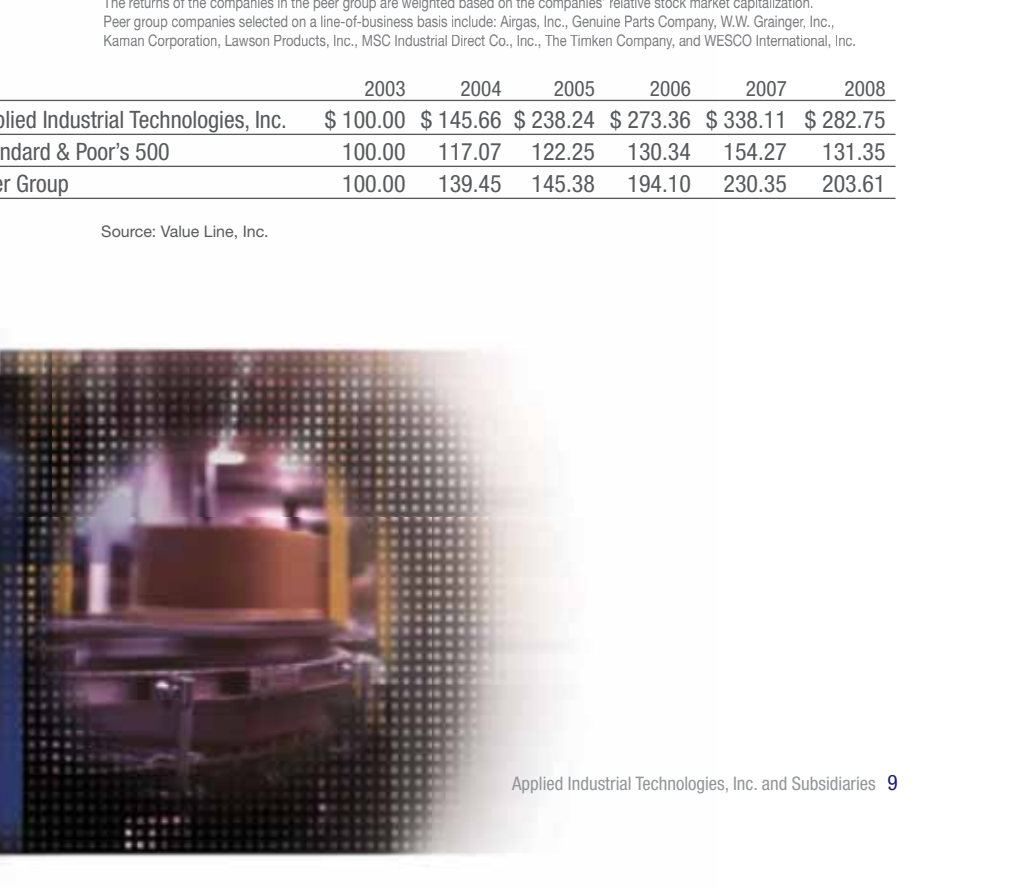
Applied Industrial Technologies, Inc., Standard & Poor's 500, and Peer Group  
(Performance Results from 7/01/03 through 6/30/08)



Assumes \$100 invested at the close of trading 6/30/03 in Applied Industrial Technologies, Inc. stock.  
Cumulative total return assumes reinvestment of dividends.  
The returns of the companies in the peer group are weighted based on the companies' relative stock market capitalization.  
Peer group companies selected on a line-of-business basis include: Airgas, Inc., Genuine Parts Company, W.W. Grainger, Inc., Kaman Corporation, Lawson Products, Inc., MSC Industrial Direct Co., Inc., The Timken Company, and WESCO International, Inc.

	2003	2004	2005	2006	2007	2008
Applied Industrial Technologies, Inc.	\$ 100.00	\$ 145.66	\$ 238.24	\$ 273.36	\$ 338.11	\$ 282.75
Standard & Poor's 500	100.00	117.07	122.25	130.34	154.27	131.35
Peer Group	100.00	139.45	145.38	194.10	230.35	203.61

Source: Value Line, Inc.



## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### OVERVIEW

With more than 4,800 associates across North America, Applied Industrial Technologies ("Applied," the "Company," "We," "Us" or "Our") is an industrial distributor that offers parts critical to the operations of MRO and OEM customers in a wide range of industries. In addition, Applied provides engineering, design and systems integration for industrial and fluid power applications, as well as customized fluid power shop, mechanical and fabricated rubber services. We have a long tradition of growth dating back to 1923, the year our business was founded in Cleveland, Ohio. During fiscal 2008, business was conducted in the United States, Canada, Mexico and Puerto Rico from 459 facilities.

Applied is an authorized distributor for more than 2,000 manufacturers and offers access to approximately 3 million stock keeping units ("SKUs"). A large portion of our business is selling replacement parts to manufacturers for repair or maintenance of machinery and equipment. When reviewing the discussion and analysis set forth below, please note that the majority of SKUs we sell in any given year were not sold in the prior year, resulting in the inability to quantify commonly used comparative metrics such as changes in product mix and volume.

Our fiscal 2008 sales hit a record \$2.1 billion dollars, an increase of 3.7% compared to the prior year. Our operating income and earnings per share increased 13.2% and 13.5%, respectively, compared to the prior year. Significant factors that contributed to these increases included the growth and improved profitability of the service center based distribution business, and the impact of acquired businesses. Gross margin held steady at 27.2%. In addition, the rate of growth in selling, distribution and administrative expense for fiscal 2008 was held below the rate of increase in sales, coming in at less than 1.0%.

Our consolidated balance sheet remains strong as shown by the increase in shareholders' equity from the June 30, 2007 level. Management of our working capital and strong earnings resulted in cash provided by operations of \$110.3 million, more than 50% higher than fiscal 2007's \$70.9 million. Working capital increased \$43.7 million from June 30, 2007 to \$409.2 million at June 30, 2008.

Applied monitors the Purchasing Managers Index (PMI) published by the Institute for Supply Management and the Manufacturers Capacity Utilization (MCU) index published by the Federal Reserve Board and considers these indices key indicators of potential business environment changes.

Both the PMI and the MCU signaled a weakening economy in fiscal 2008. Our sales activity traditionally lags these key indicators by approximately 6 months. Consistent with these indicators, we saw greater sales increase percentages in the first half of fiscal 2008 versus the second half.

Industrial production in the United States slowed in this fiscal year and there continues to be projected softness in the industrial economy in fiscal 2009 as reflected in the PMI and MCU indices.

Exclusive of the impact of any acquisitions subsequent to June 30, 2008, we are forecasting our sales in fiscal 2009 to increase in the 2.0% to 7.0% range and our gross profit percentage to be consistent with fiscal 2008 levels. In fiscal 2009, the gross profit margin will be highly dependent on our ability to manage and recover supplier price increases. We anticipate that fiscal 2009 supplier purchasing incentives will be consistent with the fiscal 2008 levels. While

we consider these purchasing incentives to be compensation for various sales, marketing and logistics services performed, when they are recognized in our statements of consolidated income, they are accounted for as a reduction of cost of sales as required by the Financial Accounting Standards Board ("FASB") rules. Our overall growth in selling, distribution and administrative expense ("SD&A") most likely will exceed our goal of one half the rate of sales growth due to continued investments in initiatives that are expected to build profitable future growth.

### YEAR ENDED JUNE 30, 2008 vs. 2007

Net sales in fiscal 2008 were \$2.1 billion or 3.7% above the prior year sales. This increase was due to improvements in our service center based distribution sales of 3.3% and in our fluid power businesses' sales of 7.7%. The increase in service center based distribution sales was primarily driven by an increase in national contract business and the recovery of supplier price increases. Within the service center based distribution segment, the impact of the strengthening Canadian currency was largely offset by a 9.3% volume decline in our Canadian market. The increase in sales at our fluid power businesses was approximately 45% attributable to favorable currency fluctuations at the Canadian locations and approximately 25% related to the VYCMEX S.A. de C.V. ("VYCMEX") acquisition. Also contributing to these increases was an additional sales day in fiscal 2008 compared to fiscal 2007.

The sales product mix for fiscal 2008 was 80.0% industrial products and 20.0% fluid power products compared to 80.2% industrial and 19.8% fluid power in the prior year.

At June 30, 2008, we had a total of 459 operating facilities in the U.S., Canada and Mexico versus 445 at June 30, 2007. The increase in facilities is largely attributed to 5 facilities from the acquisition of VYCMEX midway through the fiscal year and 10 facilities from the acquisition of Suministros Industriales Enol, S.A. de C.V. ("Enol") at the end of fiscal 2008.

Our gross profit margin maintained the 27.2% achieved in fiscal 2007. Slightly higher levels of supplier purchasing incentives were largely offset by continued pressures in gross profit margin with national contracts. LIFO inventory layer liquidations resulted in a \$0.6 million positive impact during fiscal 2008.

SD&A consists of associate compensation, benefits and other expenses associated with selling, purchasing, warehousing, supply chain management and providing marketing and distribution of the Company's products, as well as costs associated with a variety of administrative functions such as human resources, information technology, treasury, accounting, legal, and facility related expenses. SD&A increased 0.8% during fiscal 2008 compared to the prior year, but decreased as a percent of sales to 19.9% from 20.5% in 2007. Approximately one third of the fiscal 2008 increase was attributable to SD&A amounts of businesses acquired. The remainder of the increase was primarily due to increases in associate compensation tied to improved financial performance.

Operating income increased 13.2% to \$152.8 million during fiscal 2008 from \$135.0 million during 2007. As a percent of sales, operating income increased to 7.3% in fiscal 2008 from 6.7% in 2007. The \$17.8 million increase in operating income during fiscal 2008 primarily reflects the impact of higher sales at a stable gross profit percentage with only modest increases in SD&A expenses.



Interest expense, net decreased by 62.6% or \$1.5 million during fiscal 2008 compared with the prior year, primarily due to repayment of \$50.0 million of long-term debt in December 2007.

Other expense (income), net, represents certain non-operating items of income and expense. This line decreased \$1.4 million due primarily to the loss in market value in investments held by deferred compensation trusts.

Income tax expense as a percentage of income before taxes was 37.1% for fiscal 2008 and 35.7% for 2007. The increase in the effective tax rate was due to higher effective state tax rates in the current year and U.S. federal tax law changes which have eliminated the deductibility of certain expenses. Exclusive of the impact of any acquisitions subsequent to June 30, 2008, we expect our overall tax rate for fiscal 2009 to rise to around 37.5%, primarily due to the full year impact of the items noted above.

As a result of the factors addressed above, net income for fiscal 2008 increased \$9.4 million or 11.0% from the prior year. Net income per share increased 13.5% to \$2.19 in fiscal 2008 from \$1.93 in 2007. During fiscal 2008 and 2007, we repurchased 1.1 million and 1.4 million shares, respectively, which resulted in fewer shares outstanding for the year compared to the prior year. The buybacks in fiscal 2008 contributed approximately \$0.03 cents per share.

The number of Company associates was 4,831 at June 30, 2008 and 4,649 at June 30, 2007.

#### **YEAR ENDED JUNE 30, 2007 vs. 2006**

Net sales in fiscal 2007 were \$2.0 billion or 6.0% above the prior year sales. This increase was primarily due to the improvement in our service center based distribution sales and the impact of our acquisitions which accounted for approximately one quarter of the increase in sales. The increase in service center based distribution sales was driven by sales mix, volume, the recovery of supplier price increases, sales generated by acquired businesses and the strengthening of the Canadian currency. The majority of the increase in sales at our fluid power businesses was attributable to businesses acquired in fiscal 2006 which were only included for a portion of that year. There was one less sales day in fiscal 2007 compared to fiscal 2006.

The sales product mix for fiscal 2007 was 80.2% industrial products and 19.8% fluid power products compared to 81.8% industrial and 18.2% fluid power in the prior year. Business acquisitions accounted for most of the shift in sales product mix.

At June 30, 2007, we had a total of 445 operating facilities in the U.S., Canada and Mexico versus 452 at June 30, 2006.

Gross profit margin increased to 27.2% during fiscal 2007 from 27.0% during fiscal 2006. The increase in gross profit margin during fiscal 2007 primarily reflected higher levels of supplier purchasing incentives. LIFO inventory layer liquidations resulted in a \$1.6 million positive impact during fiscal 2006.

SD&A increased 3.7% during fiscal 2007 compared to the prior year, but decreased as a percent of sales to 20.5% from 21.0% in 2006. Approximately half of the fiscal 2007 increase was attributable to SD&A amounts of businesses acquired. The remainder of the increase was primarily due to increases in associate compensation tied to improved financial performance.

Operating income increased 16.8% to \$135.0 million during fiscal 2007 from \$115.6 million during 2006. As a percent of sales,

operating income increased to 6.7% in fiscal 2007 from 6.1% in 2006. The \$19.4 million increase in operating income during fiscal 2007 was primarily due to the increase in gross profit generated by the service center based distribution business, reflecting higher sales and supplier purchasing incentives, as well as control on the growth of SD&A expenses and the impact of acquired businesses.

Interest expense, net decreased by 26.5% or \$0.9 million during fiscal 2007 compared with the prior year, primarily due to an increase in interest income associated with higher average balances of temporary investments and higher interest rates.

Other expense (income), net, increased \$0.5 million due primarily to appreciation in investments held by deferred compensation trusts.

Income tax expense as a percentage of income before taxes was 35.7% for fiscal 2007 and 36.1% for 2006. The decrease in the effective tax rate was due to higher levels of non-taxable interest income in fiscal year 2007.

Net income for fiscal 2007 increased \$13.7 million or 19.0% from the prior year, reflecting the increases in sales and margins. Net income per share increased 22.9% to \$1.93 in fiscal 2007 from \$1.57 in 2006. During fiscal 2007, we repurchased 1.4 million shares, which resulted in fewer shares outstanding for the year compared to the prior year.

The number of Company associates was 4,649 at June 30, 2007 and 4,684 at June 30, 2006.

#### **LIQUIDITY AND CAPITAL RESOURCES**

Cash flows from operations depend primarily upon generating operating income, controlling investment in inventories and receivables and managing the timing of payments to suppliers. We continue to monitor and control our investments in inventories and receivables by taking advantage of supplier purchasing programs, making internal information system enhancements and accelerating receivables collection through improvements in invoice delivery, customer communications, and expanded external collection efforts. We generated \$110.3 million of cash from operating activities during fiscal 2008, \$70.9 million during 2007, and \$69.9 million during 2006. Cash provided from operations in fiscal 2008 benefited from our strong operating results. The operating cash flow increase was largely generated by a lower receivables balance, timing of certain supplier payments and improved net income. Cash flows from operations in fiscal 2007 were also impacted by the timing of certain income tax payments and the timing of receipts from certain supplier purchasing programs. In fiscal 2007, we changed how we fund our contributions to the Applied Industrial Technologies Retirement Savings Plan (section 401(k) plan). We contribute cash (which is then used by the administrator to purchase Company stock in the open market) whereas previously we satisfied our obligation by contributing treasury shares. This reduced operating cash flow in fiscal 2007 by approximately \$6.0 million.

Cash used by investing activities was \$26.8 million during fiscal 2008, \$10.2 million during 2007 and \$37.9 million during 2006. Cash was primarily used for acquisitions in fiscal 2008 and fiscal 2006, whereas it was primarily used for capital expenditures in fiscal 2007. In fiscal 2008, we acquired two Mexican distributors for \$28.7 million, of which \$22.1 million was paid at closing, net of cash acquired. In fiscal 2006, we acquired two U.S. distributors for \$28.6 million, of which \$27.7 million was paid at closing, net of cash acquired. Capital expenditures consisted primarily of information technology equipment, and buildings and improvements.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Exclusive of the impact of any acquisitions subsequent to June 30, 2008, for fiscal 2009, our capital expenditures are expected to be in the \$10.0 million to \$12.0 million range, consisting primarily of additional information system technology equipment and infrastructure investments. Depreciation for fiscal 2009 is expected to be in the range of \$12.5 million to \$13.5 million.

Cash used in financing activities was \$103.5 million during fiscal 2008, \$48.4 million during 2007 and \$53.8 million during 2006. The increase in cash used in financing activities is primarily due to repayment of \$50.0 million long-term debt in December 2007. We increased our quarterly dividend to \$0.15 per share in fiscal 2008 which accounted for approximately \$4.8 million of this increase. The amount of the dividend paid is based on judgment, financial performance and payout guidelines consistent with other industrial companies.

Comparing fiscal 2007 and fiscal 2006, we repurchased fewer shares, accounting for a reduction of \$20.8 million of cash used. Partially offsetting this was \$12.5 million in lower excess tax benefits from share-based compensation due to fewer exercises of stock options. Finally, the full year impact of the fiscal 2006 dividend rate increases accounted for an additional \$3.0 million use of cash in fiscal 2007 versus fiscal 2006. Over the last three fiscal years, we repurchased 1.1 million, 1.4 million and 2.4 million shares of the Company's common stock at an average price per share of \$29.02, \$24.26 and \$23.05, respectively.

The following table shows the Company's approximate obligations and commitments to make future payments under contractual obligations as of June 30, 2008 (in thousands):

	Total	Period Less Than 1 yr.	Period 1-3 yrs.	Period 4-5 yrs.	Period over 5 yrs.
Operating leases	\$ 68,100	\$ 20,700	\$ 24,300	\$ 13,000	\$ 10,100
Interest payments on debt	5,000	2,000	3,000		
Planned funding of postretirement obligations	42,600	3,200	8,300	8,700	22,400
Long-term debt	25,000		25,000		
Total Contractual Cash Obligations	\$ 140,700	\$ 25,900	\$ 60,600	\$ 21,700	\$ 32,500

Purchase orders for inventory and other goods and services are not included in our estimates, as purchase orders generally represent authorizations to buy rather than binding agreements. The table above excludes the liability for unrecognized income tax benefits as the Company is unable to make a reasonable estimate regarding the timing of cash settlements with the respective taxing authorities. At June 30, 2008, the Company has a gross liability for unrecognized income tax benefits of \$2,498, including interest and penalties of \$494.

The Board of Directors has authorized the repurchase of shares of the Company's stock. These purchases may be made in open market and negotiated transactions, from time to time, depending upon market conditions. At June 30, 2008, we had authorization to purchase an additional 1,065,100 shares.

Capital resources are obtained from income retained in the business, borrowings under the Company's long-term debt facilities, and from operating lease arrangements. Additionally, we have credit facilities available for borrowings as required.

See Note 5 to the consolidated financial statements for details regarding the outstanding debt amounts as of June 30, 2008 and 2007. The average borrowings totaled \$47.1 million during fiscal 2008 and \$75.0 million during fiscal 2007. In fiscal 2008, we paid off \$50.0 million of debt that matured in December 2007. The Company's remaining outstanding debt has been converted from fixed rate U.S. dollar denominated debt to fixed rate Canadian dollar denominated debt through the use of a cross currency swap. As such, consolidated interest expense is affected by changes in the exchange rates of U.S. and Canadian dollars (see Note 6 to the consolidated financial statements). The weighted average interest rate on borrowings under our debt agreements, net of the benefits from interest rate swaps, was 8.4%, 6.8% and 6.7% in fiscal 2008, 2007 and 2006, respectively. The increase in the weighted average interest rate reflects the impact of the strengthening of the Canadian dollar. We terminated certain interest rate swap agreements for favorable settlements in prior years. The settlement gains were amortized as a reduction in interest expense of \$0.8 million per year through December 2007.

We manage interest rate risk through the use of a combination of fixed rate long-term debt, variable rate borrowings under committed revolving credit agreement and interest rate swaps. At June 30, 2008, we had no variable rate debt or interest rate swaps outstanding. See Note 6 to the consolidated financial statements for additional discussion on our derivative activities.

The Company's working capital at June 30, 2008 was \$409.2 million compared to \$365.5 million at June 30, 2007. The current ratio was 3.1 at June 30, 2008 and 2.6 at June 30, 2007. The increase in working capital at June 30, 2008 was primarily due to strong operating cash flows.

The Company has a five-year committed revolving credit agreement which expires in June 2012. This agreement provides for unsecured borrowings of up to \$150.0 million. We had no borrowings outstanding under this facility at June 30, 2008. Unused lines under this facility, net of outstanding letters of credit totaling \$144.9 million, are available to fund future acquisitions or other capital and operating requirements. We also have an uncommitted long-term financing shelf facility which expires in March 2010, that enables us to borrow up to \$100.0 million at our discretion with terms of up to fifteen years. We had no outstanding borrowings under this facility at June 30, 2008.

The aggregate annual maturity of outstanding debt is \$25.0 million due in fiscal 2011.

Management expects that cash provided from operations, available credit facilities and the use of operating leases will be sufficient to finance normal working capital needs, acquisitions, investments in properties, facilities and equipment, and the purchase of additional Company common stock. Management also believes that additional long-term debt and line of credit financing could be obtained based on the Company's credit standing and financial strength.



## **SUBSEQUENT EVENT**

On July 14, 2008, Applied entered into an agreement to acquire certain assets of Fluid Power Resource, LLC, including seven fluid power businesses for cash consideration of \$169.0 million. The Company intends to fund the acquisition by drawing down its existing revolving credit facility and from its available cash. These businesses employ 455 people and for the year ended December 31, 2007 had sales of approximately \$244.0 million. Results of operations acquired will be included in the Company's results of operations from the date of closing.

## **CRITICAL ACCOUNTING POLICIES**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates at a specific point in time that affect the amounts reported in the consolidated financial statements and disclosed in the accompanying notes. Note 1 to the consolidated financial statements describes the significant accounting policies and methods used in preparation of the consolidated financial statements. Estimates are used for, but not limited to, determining the net carrying value of trade accounts receivable, inventories, recording self-insurance liabilities and other accrued liabilities. Actual results could differ from these estimates. The following critical accounting policies are impacted significantly by judgments, assumptions and estimates used in the preparation of the consolidated financial statements.

### **LIFO Inventory Valuation and Methodology**

U.S. inventories are valued at the lower of cost or market, using the last-in, first-out ("LIFO") method, and foreign inventories are valued using the average cost method. We adopted the link chain dollar value LIFO method for accounting for U.S. inventories in fiscal 1974. Approximately one-third of our domestic inventory dollars relate to LIFO layers added in the 1970s. The excess of current cost over LIFO cost is \$150.1 million as reflected on our consolidated balance sheet at June 30, 2008. The Company maintains five LIFO pools based on the following product groupings: bearings, power transmission products, rubber products, fluid power products and other products. LIFO layers and/or liquidations are determined consistently year-to-year in a manner which is in accordance with the guidance in the 1984 AICPA LIFO Issues Paper, "Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories." See Note 3 to the consolidated financial statements for further information regarding inventories.

### **Allowances for Slow-Moving and Obsolete Inventories**

We evaluate the recoverability of our slow moving or obsolete inventories at least quarterly. We estimate the recoverable cost of such inventory by product type while considering factors such as its age, historic and current demand trends, the physical condition of the inventory, as well as assumptions regarding future demand. Our ability to recover our cost for slow moving or obsolete inventory can be affected by such factors as general market conditions, future customer demand and relationships with suppliers. Historically, most of our inventories have demonstrated long shelf lives, are not highly susceptible to obsolescence and are eligible for return under various supplier return programs.

## **Allowances for Doubtful Accounts**

We evaluate the collectibility of trade accounts receivable based on a combination of factors. Initially, we estimate an allowance for doubtful accounts as a percentage of net sales based on historical bad debt experience. This initial estimate is adjusted based on recent trends of certain customers and industries estimated to be a greater credit risk, trends within the entire customer pool and changes in the overall aging of accounts receivable. While we have a large customer base that is geographically dispersed, a general economic downturn in any of the industry segments in which we operate could result in higher than expected defaults, and therefore, the need to revise estimates for bad debts.

## **Self-Insurance Liabilities**

We maintain business insurance programs with significant self-insured retention covering workers' compensation, business, automobile, general product liability and other claims. We accrue estimated losses using actuarial calculations, models and assumptions based on historical loss experience. We maintain a self-insured health benefits plan, which provides medical benefits to employees electing coverage under the plan. We maintain a reserve for all unpaid medical claims including those incurred but not reported based on historical experience and other assumptions. Although management believes that the estimated liabilities for self-insurance are adequate, the estimates described above may not be indicative of current and future losses. In addition, the actuarial calculations used to estimate self-insurance liabilities are based on numerous assumptions, some of which are subjective. We will continue to adjust our estimated liabilities for self-insurance, as deemed necessary, in the event that future loss experience differs from historical loss patterns.

## **Pension and Other Postemployment Benefit Plans**

The measurement of liabilities related to pension plans and other post-employment benefit plans is based on management's assumptions related to future events including interest rates, return on pension plan assets, rate of compensation increases, and healthcare cost trend rates. We evaluate these assumptions and adjust them as necessary. Changes to these assumptions could result in a material change to the Company's pension obligation causing a related increase or decrease in reported net operating results in the period of change in the estimate. A 1% decrease in the discount rate would result in an additional liability of \$3.3 million and additional expense of \$0.3 million. A 1% increase in the discount rate would result in a decrease in the liability of \$2.9 million and a decrease in expense of \$0.3 million. A 1% decrease in the salary scale would result in a decrease in the liability and expense of \$1.3 million and \$0.3 million, respectively. A 1% increase in the salary scale would increase the liability and expense by \$1.5 million and \$0.3 million, respectively. A 1% change in the return on assets is not material since most of the plans are non-qualified and unfunded.

In fiscal 2007, we adopted FASB Statement of Financial Accounting Standards ("SFAS") No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" ("SFAS 158"). As a result of our adoption of SFAS 158 in fiscal 2007, we recorded a decrease in other non-current assets of \$0.2 million, an increase in postemployment benefits of \$7.7 million, and a decrease in accumulated other comprehensive income (loss) of \$7.9 million.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Income Taxes

As of June 30, 2008, the Company had recognized \$35.1 million of net deferred tax assets. This figure includes a valuation allowance of \$1.0 million recorded as a result of recent changes in U.S. federal income tax regulations which resulted in limitations to the deductibility of certain expenses. Management believes that sufficient income will be earned in the future to realize its other deferred income tax assets. The realization of these deferred tax assets can be impacted by changes to tax laws, statutory tax rates and future taxable income levels.

In June 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48, which is an interpretation of SFAS No. 109, "Accounting for Income Taxes," provides guidance on the manner in which tax positions taken or to be taken on tax returns should be reflected in an entity's financial statements prior to their resolution with taxing authorities. In accordance with FIN 48, the Company recognized an immaterial cumulative effect adjustment decreasing its liability for unrecognized tax benefits, interest, and penalties and increasing the July 1, 2007 balance of retained earnings. See Note 7 for more information on income taxes.

### NEW ACCOUNTING PRONOUNCEMENTS

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles in the United States, and expands disclosures about fair value measurements. The provisions of SFAS 157 apply under other accounting pronouncements that require or permit fair value measurements; it does not expand the use of fair value in any new circumstances. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. SFAS 157 is effective for fiscal years beginning after November 15, 2007. At its February 6, 2008 meeting, the FASB agreed to defer for one year the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually). The impact of SFAS 157 on our consolidated financial statements is not expected to be material.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). This statement permits companies to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The impact of SFAS 159 on our consolidated financial statements is not expected to be material.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations" ("SFAS 141(R)"), which replaces SFAS 141. SFAS 141(R) requires most assets acquired and liabilities assumed in a business combination, contingent consideration, and certain acquired contingencies to be measured at their fair values as of the date of acquisition. SFAS 141(R) also requires that acquisition related costs and restructuring costs be recognized separately from the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008 and, therefore, will be effective for the Company for business combinations entered into after July 1, 2009.

### OTHER MATTERS

In two of the past three fiscal years, we have acquired distributors thereby extending our business over a broader geographic area. In fiscal 2008, we acquired two Mexican based distributors of industrial and fluid power products for a combined purchase price of \$28.7 million. In fiscal 2006, we acquired two U.S. based distributors of industrial and fluid power products for a combined purchase price of \$28.6 million.

Results of operations of all of the above acquisitions, which have all been accounted for as purchases, are included in the accompanying consolidated financial statements from their respective acquisition dates. The results of operations for these acquisitions are not material for all years presented.

### CAUTIONARY STATEMENT UNDER PRIVATE SECURITIES LITIGATION REFORM ACT

This Annual Report to Shareholders, including Management's Discussion and Analysis, contains statements that are forward-looking based on management's current expectations about the future. Forward-looking statements are often identified by qualifiers, such as "guidance," "expect," "expectation," "believe," "plan," "intend," "will," "should," "could," "anticipate," "forecast" and similar expressions. Similarly, descriptions of objectives, strategies, plans, or goals are also forward-looking statements. These statements may discuss, among other things, expected growth, future sales, future cash flows, future capital expenditures, future performance, and the anticipation and expectations of the Company and its management as to future occurrences and trends. The Company intends that the forward-looking statements be subject to the safe harbors established in the Private Securities Litigation Reform Act of 1995 and by the Securities and Exchange Commission in its rules, regulations and releases.

Readers are cautioned not to place undue reliance on any forward-looking statements. All forward-looking statements are based on current expectations regarding important risk factors, many of which are outside the Company's control. Accordingly, actual results may differ materially from those expressed in the forward-looking statements, and the making of those statements should not be regarded as a representation by the Company or any other person that the results expressed in the statements will be achieved. In addition, the Company assumes no obligation publicly to update or revise any forward-looking statements, whether because of new information or events, or otherwise, except as may be required by law. Important risk factors include, but are not limited to, the following: risks relating to the operations levels of our customers and the economic factors that affect them; reduced demand for our products in targeted markets due to reasons including consolidation in customer industries and the transfer of manufacturing capacity to foreign countries; changes in customer preferences for products and services of the nature and brands sold by us; changes in customer procurement policies and practices; changes in the prices for products and services relative to the cost of providing them; loss of key supplier authorizations, lack of product availability, or changes in supplier distribution programs; competitive pressures; the cost of products and energy and other operating costs; disruption of our information systems; our ability to retain and attract qualified sales and customer service personnel; our ability to identify and complete acquisitions, integrate them effectively, and realize their anticipated benefits; disruption

of operations at our headquarters or distribution centers; risks and uncertainties associated with our foreign operations, including more volatile economic conditions, political instability, cultural and legal differences, and currency exchange fluctuations; risks related to legal proceedings to which we are a party; the variability and timing of new business opportunities including acquisitions, alliances, customer relationships, and supplier authorizations; the incurrence of debt and contingent liabilities in connection with acquisitions; our ability to access capital markets as needed; changes in accounting policies and practices; organizational changes within the Company; the volatility of our stock price and the resulting impact on our consolidated financial statements; adverse regulation and legislation; and the occurrence of extraordinary events (including prolonged labor disputes, natural events and acts of god, terrorist acts, fires, floods, and accidents). Other factors and unanticipated events could also adversely affect our business, financial condition or results of operations. We discuss certain of these matters more fully throughout our “Management’s Discussion and Analysis” as well as other of our filings with the Securities and Exchange Commission, including our Annual Report on Form 10-K for the year ended June 30, 2008.

#### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The Company has evaluated its exposure to various market risk factors, including but not limited to, interest rate and foreign currency exchange risks. The Company is primarily affected by market risk exposure through the effect of changes in exchange rates and changes in interest rates.

The Company mitigates its foreign currency exposure from the Canadian dollar through the use of cross currency swap agreements as well as foreign-currency denominated debt. Hedging of the U.S. dollar denominated debt, used to fund a substantial portion of the Company’s net investment in its Canadian operations, is accomplished through the use of cross currency swaps. Any gain or loss on the hedging instrument offsets the gain or loss on the underlying debt. Translation exposures with regard to our Mexican business are not hedged. For the year ended June 30, 2008, a uniform 10% strengthening of the U.S. dollar relative to foreign currencies that affect the Company would have resulted in a \$1.3 million decrease in net income. A uniform 10% weakening of the U.S. dollar would have resulted in a \$0.7 million increase in net income.

The Company manages interest rate risk through the use of a combination of fixed rate long-term debt, variable rate borrowings under its committed revolving credit agreement and interest rate swaps. The Company had no variable rate borrowings under its committed revolving credit agreement and no interest rate swap agreements outstanding at June 30, 2008. The Company’s outstanding debt is currently at fixed interest rates at June 30, 2008 and scheduled for repayment in November 2010.



## STATEMENTS OF CONSOLIDATED INCOME

(In thousands, except per share amounts)

Year Ended June 30,	2008	2007	2006
<b>Net Sales</b>	<b>\$ 2,089,456</b>	\$ 2,014,109	\$ 1,900,780
<b>Cost of Sales</b>	<b>1,520,173</b>	1,466,057	1,386,895
	<b>569,283</b>	548,052	513,885
<b>Selling, Distribution and Administrative, including depreciation</b>	<b>416,459</b>	413,041	398,293
<b>Operating Income</b>	<b>152,824</b>	135,011	115,592
<b>Interest Expense</b>	<b>4,939</b>	5,798	5,523
<b>Interest Income</b>	<b>(4,057)</b>	(3,438)	(2,313)
<b>Other Expense (Income), net</b>	<b>227</b>	(1,179)	(717)
	<b>1,109</b>	1,181	2,493
<b>Income Before Income Taxes</b>	<b>151,715</b>	133,830	113,099
<b>Income Tax Expense</b>	<b>56,259</b>	47,808	40,800
<b>Net Income</b>	<b>\$ 95,456</b>	\$ 86,022	\$ 72,299
<b>Net Income Per Share – Basic</b>	<b>\$ 2.23</b>	\$ 1.97	\$ 1.62
<b>Net Income Per Share – Diluted</b>	<b>\$ 2.19</b>	\$ 1.93	\$ 1.57

See notes to consolidated financial statements.

## CONSOLIDATED BALANCE SHEETS

(In thousands)

June 30,	2008	2007
<b>Assets</b>		
Current assets		
Cash and cash equivalents	\$ 101,830	\$ 119,665
Accounts receivable, less allowances of \$6,119 and \$6,134	245,119	248,698
Inventories	210,723	199,886
Other current assets	48,525	32,284
Total current assets	606,197	600,533
Property – at cost		
Land	10,639	10,850
Buildings	71,142	69,938
Equipment	108,162	106,006
	189,943	186,794
Less accumulated depreciation	124,946	119,006
Property – net	64,997	67,788
Goodwill	64,685	57,550
Other intangibles	19,164	8,712
Other assets	43,728	42,786
<b>Total Assets</b>	<b>\$ 798,771</b>	<b>\$ 777,369</b>
<b>Liabilities</b>		
Current liabilities		
Accounts payable	\$ 109,822	\$ 97,166
Long-term debt payable within one year		50,395
Compensation and related benefits	56,172	59,536
Other current liabilities	31,017	27,913
Total current liabilities	197,011	235,010
Long-term debt	25,000	25,000
Postemployment benefits	37,746	36,552
Other liabilities	36,939	29,824
<b>Total Liabilities</b>	<b>296,696</b>	<b>326,386</b>
<b>Shareholders' Equity</b>		
Preferred stock – no par value; 2,500 shares authorized; none issued or outstanding		
Common stock – no par value; 80,000 shares authorized; 54,213 shares issued	10,000	10,000
Additional paid-in capital	133,078	127,569
Income retained for use in the business	543,692	473,899
Treasury shares – at cost (11,923 and 11,097 shares)	(190,944)	(159,803)
Accumulated other comprehensive income (loss)	6,249	(682)
<b>Total Shareholders' Equity</b>	<b>502,075</b>	<b>450,983</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 798,771</b>	<b>\$ 777,369</b>

See notes to consolidated financial statements.

## STATEMENTS OF CONSOLIDATED CASH FLOWS

(In thousands)

Year Ended June 30,	2008	2007	2006
<b>Cash Flows from Operating Activities</b>			
Net income	\$ 95,456	\$ 86,022	\$ 72,299
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	12,776	13,489	13,128
Deferred income taxes	(5,809)	(6,424)	1,000
Share-based compensation	3,376	2,927	2,978
Amortization of intangibles	1,663	1,045	732
Provision for losses on accounts receivable	2,595	1,462	1,953
Gain on sale of property	(1,214)	(334)	(294)
Amortization of gain on interest rate swap terminations	(395)	(791)	(791)
Treasury shares contributed to employee benefit and deferred compensation plans	812	1,921	8,937
Changes in assets and liabilities, net of acquisitions:			
Accounts receivable	8,306	(17,415)	(17,067)
Inventories	(1,484)	(7,934)	2,103
Other operating assets	(13,950)	(1,369)	(8,066)
Accounts payable	11,881	(12,220)	2,223
Other operating liabilities	(3,710)	10,546	(9,282)
<b>Net Cash provided by Operating Activities</b>	<b>110,303</b>	<b>70,925</b>	<b>69,853</b>
<b>Cash Flows from Investing Activities</b>			
Property purchases	(8,410)	(11,192)	(11,057)
Proceeds from property sales	1,372	1,275	1,244
Net cash paid for acquisition of businesses, net of cash acquired of \$2,355 and \$968 in 2008 and 2006, respectively	(22,105)		(27,672)
Other	2,304	(302)	(429)
<b>Net Cash used in Investing Activities</b>	<b>(26,839)</b>	<b>(10,219)</b>	<b>(37,914)</b>
<b>Cash Flows from Financing Activities</b>			
Long-term debt repayment	(50,000)		
Purchases of treasury shares	(33,224)	(33,988)	(54,778)
Dividends paid	(25,728)	(20,970)	(17,973)
Excess tax benefits from share-based compensation	3,761	3,885	16,400
Exercise of stock options	1,664	2,663	2,569
<b>Net Cash used in Financing Activities</b>	<b>(103,527)</b>	<b>(48,410)</b>	<b>(53,782)</b>
<b>Effect of Exchange Rate Changes on Cash</b>	<b>2,228</b>	<b>941</b>	<b>1,135</b>
(Decrease) increase in cash and cash equivalents	(17,835)	13,237	(20,708)
Cash and cash equivalents at beginning of year	119,665	106,428	127,136
<b>Cash and Cash Equivalents at End of Year</b>	<b>\$ 101,830</b>	<b>\$ 119,665</b>	<b>\$ 106,428</b>
<b>Supplemental Cash Flow Information</b>			
Cash paid during the year for:			
Income taxes	\$ 60,049	\$ 42,857	\$ 31,337
Interest	\$ 4,763	\$ 5,488	\$ 5,290

See notes to consolidated financial statements.



## STATEMENTS OF CONSOLIDATED SHAREHOLDERS' EQUITY

(In thousands, except per share amounts)

For the Years Ended June 30, 2008, 2007 and 2006

	Shares of Common Stock Outstanding	Common Stock	Additional Paid-in Capital	Income Retained for Use in the Business	Treasury Shares - at Cost	Unearned Restricted Common Stock Compensation	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
<b>Balance at July 1, 2005</b>	45,002	\$ 10,000	\$ 103,240	\$ 354,521	\$ (72,660)	\$ (825)	\$ (989)	\$ 393,287
Net income				72,299				72,299
Unrealized gain on cash flow hedge, net of income tax of \$384							598	598
Unrealized gain on investment securities available for sale, net of income tax of \$43							72	72
Reduction in minimum pension liability, net of income tax of \$283							542	542
Foreign currency translation adjustment, net of income tax of \$1,258							4,573	4,573
<b>Total comprehensive income</b>								<b>78,084</b>
Cash dividends – \$.40 per share				(17,973)				(17,973)
Purchases of common stock for treasury	(2,379)				(54,778)			(54,778)
Treasury shares issued for:								
Retirement Savings Plan contributions	348		4,892		3,583			8,475
Exercise of stock options	1,088		11,279		(6,945)			4,334
Deferred compensation plans	21		269		193			462
Compensation expense – stock options and appreciation rights			2,658					2,658
Amortization of restricted common stock compensation			320					320
Reclassification of unearned restricted stock compensation due to the adoption of SFAS 123(R)			(825)			825		
Other	(13)		313		(360)			(47)
<b>Balance at June 30, 2006</b>	44,067	10,000	122,146	408,847	(130,967)	0	4,796	414,822
Net income				86,022				86,022
Unrealized loss on cash flow hedge, net of income tax of \$(59)							(93)	(93)
Unrealized gain on investment securities available for sale, net of income tax of \$68							110	110
Increase in minimum pension liability, net of income tax of \$(185)							(301)	(301)
Foreign currency translation adjustment, net of income tax of \$194							2,703	2,703
<b>Total comprehensive income</b>								<b>88,441</b>
Cash dividends – \$.48 per share				(20,970)				(20,970)
Purchases of common stock for treasury	(1,401)				(33,988)			(33,988)
Treasury shares issued for:								
Retirement Savings Plan contributions	5		47		65			112
Exercise of stock options	366		796		4,157			4,953
Deferred compensation plans	78		1,613		1,046			2,659
Compensation expense – stock options and appreciation rights			2,494					2,494
Amortization of restricted common stock compensation			433					433
Adjustment to initially apply SFAS 158, net of income tax of \$(4,899)							(7,897)	(7,897)
Other	1		40		(116)			(76)
<b>Balance at June 30, 2007</b>	43,116	10,000	127,569	473,899	(159,803)	0	(682)	450,983
Net income				95,456				95,456
Unrealized gain on cash flow hedge, net of income tax of \$414							645	645
Unrealized gain on investment securities available for sale, net of income tax of \$50							82	82
Pension and postemployment adjustment, net of income tax of \$293							478	478
Foreign currency translation adjustment, net of income tax of \$912							5,726	5,726
<b>Total comprehensive income</b>								<b>102,387</b>
Cash dividends – \$.60 per share				(25,728)				(25,728)
Purchases of common stock for treasury	(1,145)				(33,224)			(33,224)
Treasury shares issued for:								
Exercise of stock options	315		1,800		2,330			4,130
Deferred compensation plans	26		410		402			812
Compensation expense – stock options and appreciation rights			2,999					2,999
Amortization of restricted common stock compensation			377					377
Other	(22)		(77)	65	(649)			(661)
<b>Balance at June 30, 2008</b>	42,290	\$ 10,000	\$ 133,078	\$ 543,692	\$ (190,944)	\$ 0	\$ 6,249	\$ 502,075

See notes to consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

### NOTE 1: BUSINESS AND ACCOUNTING POLICIES

#### Business

Applied Industrial Technologies, Inc. and subsidiaries (the "Company") is one of North America's leading distributors of industrial products. Industrial products include bearings, power transmission components, fluid power components and systems, industrial rubber products, linear components, tools, safety products, general maintenance, and a variety of mill supply products. Fluid power products include hydraulic, pneumatic, lubrication, and filtration components and systems. The Company also provides mechanical, rubber shop and fluid power services. The Company offers technical application support for these products and provides solutions to help customers minimize downtime and reduce overall procurement costs. Although the Company does not generally manufacture the products it sells, it does assemble and repair certain products and systems. Most of the Company's sales are in the maintenance and replacement markets to customers in a wide range of industries, principally in North America.

#### Consolidation

The consolidated financial statements include the accounts of Applied Industrial Technologies, Inc. and its subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation. The financial results of the Company's Canadian and Mexican subsidiaries are included in the consolidated financial statements for the 12 months ended May 31. Prior to June 30, 2006, the Company was considered the primary beneficiary for iSource Performance Materials, LLC (iSource), a certified minority-owned distributor, and included their accounts in the consolidated financial statements. Effective June 30, 2006, the Company ended its venture with iSource and stopped including its operating results and balances in the Company's consolidated financial statements.

#### Foreign Currency

The financial statements of the Company's Canadian and Mexican subsidiaries are measured using local currencies as their functional currencies. Assets and liabilities are translated into U.S. dollars at current exchange rates, while income and expenses are translated at average exchange rates. Translation gains and losses are included as components of accumulated other comprehensive income (loss) in shareholders' equity. Transaction gains and losses included in the statements of consolidated income were not material.

#### Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the period. Actual results may differ from the estimates and assumptions used in preparing the consolidated financial statements.

#### Cash and Cash Equivalents

The Company considers all short-term, highly liquid investments with maturities of three months or less at the date of purchase to be cash equivalents. Cash and cash equivalents are carried at cost, which approximates market value.

#### Marketable Securities

The primary marketable security investments of the Company, included in other assets, are classified as trading securities and reported at fair value, based on quoted market prices. These marketable securities (money market and mutual funds) totaled \$10,527 and \$10,925 at June 30, 2008 and 2007, respectively. Unrealized gains and losses are recorded in other expense (income), net in the statements of consolidated income and reflect changes in the fair value of the investment during the period.

#### Concentration of Credit Risk

The Company has a broad customer base representing many diverse industries doing business throughout North America. As such, the Company does not believe that a significant concentration of credit risk exists.

The Company maintains its cash and cash equivalents with federally insured financial institutions. Deposits held with banks may exceed insurance limits. These deposits may be redeemed upon demand.

#### Allowances for Doubtful Accounts

The Company evaluates the collectibility of trade accounts receivable based on a combination of factors. Initially, the Company estimates an allowance for doubtful accounts as a percentage of net sales based on historical bad debt experience. This initial estimate is adjusted based on recent trends of customers and industries estimated to be a greater credit risk, trends within the entire customer pool and changes in the overall aging of accounts receivable. While the Company has a large customer base that is geographically dispersed, a general economic downturn in any of the industry segments in which the Company operates could result in higher than expected defaults, and therefore, the need to revise estimates for bad debts.

#### Inventories

U.S. inventories are valued at the lower of cost or market, using the last-in, first-out ("LIFO") method, and foreign inventories are valued using the average cost method. The Company adopted the link chain dollar value LIFO method of accounting for U.S. inventories in fiscal 1974. At June 30, 2008, approximately one-third of the Company's domestic inventory dollars relate to LIFO layers added in the 1970s. The Company maintains five LIFO pools based on the following product groupings: bearings, power transmission products, rubber products, fluid power products and other products. LIFO layers and/or liquidations are determined consistently year-to-year in a manner which is in accordance with the guidance in the 1984 AICPA LIFO Issues Paper, "Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories." See Note 3 for further information regarding inventories.

The Company evaluates the recoverability of its slow moving or obsolete inventories at least quarterly. The Company estimates the recoverable cost of such inventory by product type while considering factors such as its age, historic and current demand trends, the physical condition of the inventory as well

as assumptions regarding future demand. The Company's ability to recover its cost for slow moving or obsolete inventory can be affected by such factors as general market conditions, future customer demand and relationships with suppliers. Historically, the Company's inventories have demonstrated long shelf lives, are not highly susceptible to obsolescence and are eligible for return under various supplier return programs.

#### **Supplier Purchasing Programs**

The Company enters into agreements with certain suppliers providing for inventory purchase incentives. The Company's inventory purchase incentive arrangements are unique to each supplier and are generally annual programs ending at either the Company's fiscal year end or the supplier's year end. Incentives are received in the form of cash or credits against purchases upon attainment of specified purchase volumes and are received monthly, quarterly or annually based upon actual purchases for such period. The incentives are generally a specified percentage of the Company's net purchases based upon achieving specific purchasing volume levels. These percentages can increase or decrease based on changes in the volume of purchases. The Company accrues for the receipt of these inventory purchase incentives based upon cumulative purchases of inventory. The percentage level utilized is based upon the estimated total volume of purchases expected during the life of the program. Each supplier program is analyzed, reviewed and reconciled each quarter as information becomes available to determine the appropriateness of the amount estimated to be received. Upon program completion, differences between estimates and actual incentives subsequently received have not been material. Benefits under these supplier purchasing programs are recognized under the Company's LIFO inventory accounting method as a reduction of cost of sales when the inventories representing these purchases are recorded as cost of sales. The Company's accounting for inventory purchase incentives is in accordance with guidance issued by the Financial Accounting Standards Board ("FASB") in EITF 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor." Accrued incentives expected to be settled as a credit against purchases are reported on the consolidated balance sheet as an offset to amounts due to the related supplier.

#### **Property and Depreciation**

Property and equipment are recorded at cost. Depreciation of buildings and equipment is computed using the straight-line method over the estimated useful lives of the assets and is included in selling, distribution and administrative expenses in the accompanying statements of consolidated income. Buildings, building improvements and leasehold improvements are depreciated over ten to thirty years or the life of the lease if a shorter period, and equipment is depreciated over three to eight years. The carrying values of property and equipment are reviewed for impairment when events or changes in circumstances indicate that the recorded value cannot be recovered from undiscounted future cash flows. Impairment losses, if any, are measured based upon the difference between the carrying amount and the fair value of the assets.

#### **Goodwill and Other Intangible Assets**

Goodwill is recognized as the excess cost of an acquired entity over the net amount assigned to assets acquired and liabilities assumed. Goodwill is not amortized.

The Company recognizes acquired intangible assets such as customer relationships, exclusive supplier distribution agreements, trade names, and non-competition agreements apart from goodwill. Customer relationship intangibles are amortized using the sum-of-the-years-digits method over estimated useful lives consistent with assumptions used in the determination of their value. Amortization of all other intangible assets is computed using the straight-line method over the estimated period of benefit. Amortization of intangible assets is included in selling, distribution and administrative expenses in the accompanying statements of consolidated income. The weighted-average amortization period for intangible assets with an unamortized balance as of June 30, 2008 was 12 years for customer relationships, 11 years for exclusive supplier distribution agreements, 11 years for trade names, and 8 years for non-competition agreements.

Goodwill and other intangible assets are tested for impairment annually as of January 1 or when changes in conditions indicate carrying value may not be recoverable. Impairment exists when the carrying value of goodwill or other intangible assets exceed their fair value. The results of the Company's annual testing indicated no impairment.

#### **Self-Insurance Liabilities**

The Company maintains business insurance programs with significant self-insured retention covering workers' compensation, business, automobile, general product liability and other claims. The Company accrues estimated losses including those incurred but not reported using actuarial calculations, models and assumptions based on historical loss experience. The Company maintains a self-insured health benefits plan, which provides medical benefits to employees electing coverage under the plan. The Company estimates its reserve for all unpaid medical claims including those incurred but not reported based on historical experience and other assumptions.

#### **Revenue Recognition**

Sales are recognized when the sales price is fixed, collectibility is reasonably assured and the product's title and risk of loss is transferred to the customer. Typically, these conditions are met when the product is shipped to the customer. The Company charges shipping and handling fees when products are shipped or delivered to a customer, and includes such amounts in net sales. The Company reports its sales net of the amount of actual sales returns and the amount of reserves established for anticipated sales returns based on historical return rates. Sales tax collected from customers is excluded from net sales in the accompanying statements of consolidated income.

#### **Shipping and Handling Costs**

The Company records freight payments to third parties in cost of sales and internal delivery costs in selling, distribution and administrative expenses in the accompanying statements of consolidated income. Internal delivery costs in selling, distribution and administrative expenses were approximately \$17,000, \$16,000 and \$15,500 for the fiscal years ended June 30, 2008, 2007 and 2006, respectively.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

### Income Taxes

Income taxes are determined based upon income and expenses recorded for financial reporting purposes. Deferred income taxes are recorded for estimated future tax effects of differences between the bases of assets and liabilities for financial reporting and income tax purposes, giving consideration to enacted tax laws.

Effective July 1, 2007, the Company adopted FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes" ("FIN 48"). This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109 "Accounting for Income Taxes". FIN 48 prescribes a recognition threshold and measurement attribute for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods.

### Net Income Per Share

The following is a computation of the basic and diluted earnings per share:

Year Ended June 30,	2008	2007	2006
Net Income	\$ 95,456	\$ 86,022	\$ 72,299
Average Shares Outstanding:			
Weighted average common shares outstanding for basic computation	42,797	43,630	44,620
Dilutive effect of common stock equivalents	755	865	1,560
Weighted average common shares outstanding for dilutive computation	43,552	44,495	46,180
Net Income Per Share – Basic	\$ 2.23	\$ 1.97	\$ 1.62
Net Income Per Share – Diluted	\$ 2.19	\$ 1.93	\$ 1.57

Options to acquire and stock appreciation rights relating to 255, 460, and 301 shares of common stock were outstanding at June 30, 2008, 2007 and 2006, respectively, but were not included in the computation of diluted earnings per share for the fiscal years then ended as they were anti-dilutive.

### Treasury Shares

Shares of common stock repurchased by the Company are recorded at cost as treasury shares and result in a reduction of shareholders' equity in the consolidated balance sheets. The Company uses the weighted average cost method for determining the cost of shares reissued. The difference between the cost of the shares and the reissuance price is added to or deducted from additional paid-in capital.

### Accumulated Other Comprehensive Income (Loss)

Accumulated other comprehensive income (loss) is comprised of the following:

June 30,	2008	2007
Unrealized loss on cash flow hedge, net of taxes	\$ (19)	\$ (664)
Unrealized gain on investment securities available for sale, net of taxes	338	256
Foreign currency translation, net of taxes	15,966	10,240
Pension liability, net of taxes	(10,036)	(10,514)
Total accumulated other comprehensive income (loss)	\$ 6,249	\$ (682)

### New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" ("SFAS 157"). This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles in the United States, and expands disclosures about fair value measurements. The provisions of SFAS 157 apply under other accounting pronouncements that require or permit fair value measurements; it does not expand the use of fair value in any new circumstances. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. SFAS 157 is effective for fiscal years beginning after November 15, 2007. At its February 6, 2008 meeting, the FASB agreed to defer for one year the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (that is, at least annually). The impact of SFAS 157 on the Company's consolidated financial statements is not expected to be material.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). This statement permits companies to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The impact of SFAS 159 on the Company's consolidated financial statements is not expected to be material.

In December 2007, the FASB issued SFAS No. 141(R), "Business Combinations" ("SFAS 141(R)"), which replaces SFAS 141. SFAS 141(R) requires most assets acquired and liabilities assumed in a business combination, contingent consideration, and certain acquired contingencies to be measured at their fair values as of the date of acquisition. SFAS 141(R) also requires that acquisition related costs and restructuring costs be recognized separately from the business combination. SFAS 141(R) is effective for fiscal years beginning after December 15, 2008 and, therefore, will be effective for the Company for business combinations entered into after July 1, 2009.

## Reclassifications

Certain prior period amounts have been reclassified to conform to current year presentation.

## NOTE 2: BUSINESS COMBINATIONS

In two of the past three fiscal years, the Company acquired distributors to complement and extend its business over a broader geographic area. In fiscal 2008, the Company acquired two Mexican based distributors for a combined purchase price of \$28,703. VYCMEX S.A. de C.V., a distributor of fluid power products, was acquired in December 2007 and Suministros Industriales Enol, S.A. de C.V., an industrial products distributor, was acquired in May 2008. The purchase price allocations are considered preliminary as reflected in the financial statements; and will be finalized as we obtain more information regarding asset valuations. In fiscal 2006, the Company acquired two U.S. based distributors of industrial and fluid power products for a combined purchase price of \$28,639.

Results of operations of the above acquisitions, which have been accounted for as purchases, are included in the accompanying consolidated financial statements from their respective acquisition dates based on the Company's consolidation policy. The results of operations for these acquisitions are not material for all years presented.

## NOTE 3: INVENTORIES

Inventories consist of the following:

June 30,	2008	2007
U.S. inventories at current cost	\$ 305,377	\$ 294,897
Foreign inventories at average cost	55,441	46,333
	<b>360,818</b>	341,230
Less: Excess of current cost over LIFO cost for U.S. inventories	150,095	141,344
Inventories on consolidated balance sheets	<b>\$ 210,723</b>	\$ 199,886

Reductions in certain U.S. inventories during fiscal 2008 and 2006 resulted in the liquidation of LIFO inventory quantities carried at lower costs prevailing in prior years. The effect of the liquidations increased gross profit by \$626 and \$1,647, net income by \$383 and \$1,013, and diluted net income per share by \$0.01 and \$0.02, respectively. There were no LIFO layer liquidations during fiscal 2007.

## NOTE 4: GOODWILL AND OTHER INTANGIBLES

The changes in the carrying amount of goodwill for the years ended June 30, 2008 and 2007, are as follows:

	Service Center Based Distribution Segment	Fluid Power Businesses Segment	Total
Balance at July 1, 2006	\$ 56,963	\$ 259	\$ 57,222
Other, primarily currency translation	341	(13)	328
Balance at June 30, 2007	57,304	246	57,550
Goodwill acquired during the year	3,486	2,692	6,178
Other, primarily currency translation	657	300	957
Balance at June 30, 2008	<b>\$ 61,447</b>	<b>\$ 3,238</b>	<b>\$ 64,685</b>

The Company's other intangible assets resulting from business combinations are amortized over their estimated period of benefit and consist of the following:

June 30, 2008	Amount (a)	Accumulated Amortization	Net Book Value
Customer relationships	\$ 11,824	\$ 2,716	\$ 9,108
Exclusive supplier distribution agreements	4,731	575	4,156
Trade names	4,240	278	3,962
Non-competition agreements	2,441	503	1,938
	<b>\$ 23,236</b>	<b>\$ 4,072</b>	<b>\$ 19,164</b>
June 30, 2007	Amount (a)	Accumulated Amortization	Net Book Value
Customer relationships	\$ 8,347	\$ 1,477	\$ 6,870
Exclusive supplier distribution agreements	1,071	311	760
Trade names	924	144	780
Non-competition agreements	657	355	302
	<b>\$ 10,999</b>	<b>\$ 2,287</b>	<b>\$ 8,712</b>

(a) Amounts include the impact of foreign currency translation. Fully amortized amounts are written off.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

During fiscal 2008, the Company recorded intangible assets of \$3,210 for customer relationships, \$3,440 for exclusive supplier distribution agreements, \$3,200 for trade names and \$1,740 for non-competition agreements in connection with the acquisition of two Mexican distributors of industrial and fluid power products (see Note 2).

During fiscal 2006, the Company recorded intangible assets of \$4,890 for customer relationships, \$290 for exclusive supplier distribution agreements, \$750 for trade names and \$200 for non-competition agreements in connection with the acquisition of two U.S. distributors of industrial and fluid power products (see Note 2).

Amortization expense for other intangible assets totaled \$1,663, \$1,045, and \$732 in fiscal 2008, 2007 and 2006, respectively. Amortization of other intangible assets at June 30, 2008 is expected to be \$3,100 for 2009, \$2,800 for 2010, \$2,600 for 2011, \$2,300 for 2012 and \$2,000 for 2013.

### NOTE 5: DEBT

Long-term debt consists of:

June 30,	2008	2007
7.98% Private placement debt, due at maturity in November 2010	\$ 25,000	\$ 25,000
6.60% Senior \$50,000 unsecured term notes, paid off in December 2007		50,395
Total long-term debt	25,000	75,395
Less: Payable within one year		50,395
Total long-term debt less current portion	\$ 25,000	\$ 25,000

Based upon current market rates for debt of similar maturities, the Company's long-term debt had an estimated fair value of \$26,336 and \$76,995 as of June 30, 2008 and 2007, respectively.

The Company has a revolving credit facility with a group of banks expiring in June 2012. This agreement provides for unsecured borrowings of up to \$150,000 at various interest rate options, none of which is in excess of the banks' prime rate at interest determination dates. Fees on this facility range from .07% to .15% per year on the average amount of the total revolving credit commitments during the year. Unused lines under this facility, net of outstanding letters of credit of \$5,105 to secure certain insurance obligations, totaled \$144,895 at June 30, 2008 and are available to fund future acquisitions or other capital and operating requirements. The Company had no borrowings outstanding under this facility at June 30, 2008.

The Company has an agreement with Prudential Insurance Company for an uncommitted shelf facility that enables the Company to borrow up to \$100,000 in additional long-term financing at the Company's sole discretion with terms of up to fifteen years. The agreement expires in March 2010. There were no borrowings at June 30, 2008.

The revolving credit facility, private placement debt and uncommitted shelf facility contain restrictive covenants regarding liquidity, tangible net worth, financial ratios, and other covenants. At June 30, 2008, the most restrictive of these covenants required that the Company have consolidated income before interest, taxes, depreciation and amortization at least equal to 300% of net interest expense. At June 30, 2008, the Company was in compliance with all covenants.

### NOTE 6: RISK MANAGEMENT ACTIVITIES

The Company is exposed to market risks, primarily resulting from changes in currency exchange rates and interest rates. To manage these risks, the Company may enter into derivative transactions pursuant to the Company's written policy. These transactions are accounted for in accordance with SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). The Company does not hold or issue derivative financial instruments for trading purposes.

In November 2000, the Company entered into two 10-year cross-currency swap agreements to manage its foreign currency risk exposure on private placement borrowings related to its wholly owned Canadian subsidiary. The cross-currency swaps effectively convert \$25,000 of debt, and the associated interest payments, from 7.98% fixed rate U.S. dollar denominated debt to 7.75% fixed rate Canadian dollar denominated debt. The terms of the two cross-currency swaps mirror the terms of the private placement borrowings.

The Company has designated one of the cross-currency swaps, with a \$20,000 U.S. notional amount, as a foreign currency cash flow hedge. The fair value of the cross-currency swap was a liability of \$10,479 and \$9,372 at June 30, 2008 and 2007, respectively. These liabilities were recorded in other liabilities and the related unrealized losses are included in accumulated other comprehensive income (loss), (net of tax). The second cross-currency swap, however, has not been designated as a hedging instrument under the hedge accounting provisions of SFAS 133. The fair value of this cross-currency swap was a liability of \$2,620 and \$2,343 at June 30, 2008 and 2007, respectively. Changes in the fair value of this derivative instrument are recorded in the statements of consolidated income as a component of other expense (income), net.



## NOTE 7: INCOME TAXES

### Income Before Income Taxes

The components of income before income taxes are as follows:

Year Ended June 30,	2008	2007	2006
U.S.	\$ 136,179	\$ 119,275	\$ 100,462
Foreign	15,536	14,555	12,637
Total income before taxes	\$ 151,715	\$ 133,830	\$ 113,099

### Provision

The provision (benefit) for income taxes consists of:

Year Ended June 30,	2008	2007	2006
Current:			
Federal	\$ 49,532	\$ 43,325	\$ 31,100
State and local	7,025	5,341	3,600
Foreign	5,511	5,566	5,100
Total current	62,068	54,232	39,800
Deferred:			
Federal	(5,028)	(5,914)	900
State and local	(346)	(342)	400
Foreign	(435)	(168)	(300)
Total deferred	(5,809)	(6,424)	1,000
Total	\$ 56,259	\$ 47,808	\$ 40,800

The exercise of non-qualified stock options and stock appreciation rights during fiscal 2008, 2007 and 2006 resulted in \$3,140, \$2,860 and \$16,155, respectively, of income tax benefits to the Company derived from the difference between the market price at the date of exercise and the option price. Vesting of stock awards and other stock compensation in fiscal 2008 and 2007 resulted in \$577 and \$1,025, respectively, of incremental income tax benefits over the amounts previously reported for financial reporting purposes. These tax benefits were recorded in additional paid-in capital.

### Effective Tax Rates

The following reconciles the federal statutory income tax rate and the Company's effective tax rate:

Year Ended June 30,	2008	2007	2006
Statutory tax rate	35.0%	35.0%	35.0%
Effects of:			
State and local income taxes	2.8	2.3	2.4
Valuation allowance	.7		
Foreign income taxes	(.9)	(.8)	(.7)
Deductible dividend	(.5)	(.5)	(.6)
Other, net		(.3)	
Effective tax rate	37.1%	35.7%	36.1%

### Consolidated Balance Sheets

Significant components of the Company's net deferred tax assets are as follows:

June 30,	2008	2007
Deferred tax assets:		
Compensation liabilities not currently deductible	\$ 33,248	\$ 30,171
Expenses and reserves not currently deductible	7,523	7,454
Goodwill and other intangibles		563
Net operating loss carryforwards (expiring in years 2014 - 2021)	451	438
Other	880	932
Total deferred tax assets	42,102	39,558
Less: Valuation allowance	(1,019)	
Deferred tax assets net of valuation allowance	41,083	39,558
Deferred tax liabilities:		
Currency translation	(4,024)	(3,113)
Inventories	(1,813)	(4,061)
Depreciation and differences in property bases	(124)	(1,471)
Other	(52)	
Total deferred tax liabilities	(6,013)	(8,645)
Net deferred tax assets	\$ 35,070	\$ 30,913

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

At June 30, 2008 and 2007, \$9,288 and \$7,710, respectively, of the net deferred tax assets were included in other current assets and \$25,782 and \$19,597, respectively, were included in other assets in the accompanying consolidated balance sheets. Valuation allowances are provided against deferred tax assets where it is considered more-likely-than-not that the Company will not realize the benefit of such assets. Recent changes in U.S. tax regulations resulted in limitations to the deductibility of certain expenses. Management believes it is not likely the Company will be able to utilize certain expenses and has established a valuation allowance against them. The net deferred tax asset is the amount management believes is more likely than not of being realized. The realization of these deferred tax assets can be impacted by changes to tax laws, statutory rates and future income levels.

No provision has been made for income taxes on undistributed earnings of non-U.S. subsidiaries of approximately \$62.0 million at June 30, 2008, since it is the Company's intention to indefinitely reinvest undistributed earnings of its foreign subsidiaries. Determination of the net amount of unrecognized taxes with respect to these earnings is not practicable; however, foreign tax credits would be available to partially reduce U.S. income taxes in the event of a distribution.

### Unrecognized Income Tax Benefits

The Company and its subsidiaries file income tax returns in the U.S. federal, various state and local and foreign jurisdictions. Effective July 1, 2007, the Company adopted FIN 48. As a result of adopting FIN 48, the Company reduced its liability by approximately \$65 for "unrecognized tax benefits," defined as the aggregate tax effect of differences between tax return positions and the benefits recognized in the financial statements. In accordance with FIN 48, such amount was accounted for as an increase to the beginning balance of retained earnings.

The following is a reconciliation of the Company's total gross unrecognized tax benefits for the year ended June 30, 2008:

	<b>2008</b>
Unrecognized tax benefits at July 1, 2007	<b>\$ 1,903</b>
Additions	
Current year tax positions	<b>369</b>
Prior year tax positions	<b>(31)</b>
Expirations of statutes of limitations	<b>(216)</b>
Settlements	<b>(21)</b>
Unrecognized tax benefits at June 30, 2008	<b>\$ 2,004</b>

Included in the balance of unrecognized tax benefits at June 30, 2008, are \$1,124 of tax benefits that, if recognized, would affect the effective tax rate.

The Company recognizes accrued interest and penalties related to unrecognized tax benefits in the provision for income taxes. The Company accrued \$97 during the year for interest and penalties related to unrecognized benefits and, as of June 30, 2008 has recognized a liability for penalties and interest of \$494. The Company does not anticipate a significant change to the total amount of unrecognized tax benefits within the next 12 months.

The Company is subject to U.S. federal jurisdiction income tax examinations for the tax years 2005 through 2008. In addition, the Company is subject to foreign, state and local income tax examinations for the tax years 2003 through 2008.

Effective with the adoption of FIN 48, the majority of the Company's unrecognized tax benefits are classified as noncurrent liabilities since payment of cash is not expected within one year. Prior to the adoption of FIN 48, the Company classified unrecognized tax benefits in current liabilities.

### NOTE 8: SHAREHOLDERS' EQUITY

#### Share-Based Incentive Plans

Following its approval by the Company's shareholders in October 2007, the 2007 Long-Term Performance Plan (the "2007 Plan") replaced the 1997 Long-Term Performance Plan. The 2007 Plan, which expires in 2012, provides for granting of stock options, stock appreciation rights ("SARs"), stock awards, cash awards, and such other awards or combination thereof as the Executive Organization and Compensation Committee or the Corporate Governance Committee of the Board of Directors may determine to officers, other key associates and members of the Board of Directors. Grants are generally made by the two committees at regularly scheduled meetings. The aggregate number of shares of common stock which may be awarded under the 2007 Plan is 2,000. Shares available for future grants at June 30, 2008 were 1,963.

#### Stock Option and Stock Appreciation Rights

SARs and non-qualified stock options are granted with an exercise price equal to the market price of the Company's common stock at the date of grant. SARs and stock option awards generally vest over four years of continuous service and have 10-year contractual terms.

Compensation expense related to stock options and SARs recorded for the years ended June 30, 2008, 2007 and 2006 was \$2,999, \$2,494 and \$2,658, respectively. Such amounts are included in selling, distribution and administrative expense in the accompanying statements of consolidated income. Compensation expense for stock options and SARs has been determined using the Black-Scholes option pricing model. Determining the appropriate fair value of share-based awards requires management to select a fair value model and make certain estimates and assumptions.

The weighted average assumptions used for SARs and stock option grants issued in fiscal 2008, 2007 and 2006 are:

	2008	2007	2006
Expected life, in years	5.3	5.1	7.2
Risk free interest rate	4.4%	4.8%	4.3%
Dividend yield	2.2%	2.2%	1.4%
Volatility	45.9%	46.7%	42.3%

The expected life is based upon historical exercise experience of the officers, other key associates and members of the Board of Directors currently awarded share-based compensation. The risk free interest rate is based upon the U.S. Treasury zero-coupon bonds with remaining terms equal to the expected life of the stock options and SARs. The assumed dividend yield has been estimated based upon the Company's historical results and expectations for changes in dividends and stock prices. The volatility assumption is calculated based upon historical daily price observations of the Company's common stock for a period equal to the expected life.

It has been the Company's practice to issue shares from Treasury to satisfy requirements of SARs and stock option exercises. SARs are redeemable solely in Company common stock. The exercise price of stock option awards may be settled by the holder with cash or by tendering Company common stock. A summary of stock option and SARs activity is presented below:

(Share amounts in thousands)	Shares	Weighted Average Exercise Price
<b>2008</b>		
Outstanding, beginning of year	2,384	\$ 13.15
Granted	263	25.32
Exercised	(452)	10.43
Outstanding, end of year	2,195	\$ 15.17
Exercisable at end of year	1,596	\$ 12.61
Weighted average fair value of SARs and stock options granted during year		\$ 9.79
<b>2007</b>		
Outstanding, beginning of year	2,486	\$ 11.23
Granted	319	22.11
Exercised	(421)	8.61
Outstanding, end of year	2,384	\$ 13.15
Exercisable at end of year	1,533	\$ 10.63
Weighted average fair value of SARs and stock options granted during year		\$ 8.74
<b>2006</b>		
Outstanding, beginning of year	4,302	\$ 8.68
Granted	306	23.40
Exercised	(2,103)	7.76
Expired/canceled	(19)	14.04
Outstanding, end of year	2,486	\$ 11.23
Exercisable at end of year	1,381	\$ 9.85
Weighted average fair value of SARs and stock options granted during year		\$ 10.29

The weighted average remaining contractual terms for SARs/stock options outstanding and exercisable at June 30, 2008 were 5.6 and 4.7 years, respectively. The aggregate intrinsic values of SARs/stock options outstanding and exercisable at June 30, 2008 were \$20,107 and \$18,528, respectively. The aggregate intrinsic value of the SARs/stock options exercised during fiscal 2008, 2007 and 2006 was \$9,356, \$7,887 and \$41,966, respectively.

A summary of the status of the Company's nonvested stock options and SARs at June 30, 2008, all of which are expected to vest is presented below:

(Share amounts in thousands)	Shares	Weighted Average Grant-Date Fair Value
<b>2008</b>		
Nonvested, beginning of year	851	\$ 6.77
Granted	263	9.79
Vested	(515)	6.19
Nonvested, end of year	599	\$ 8.64

As of June 30, 2008, unrecognized compensation cost related to stock options and SARs amounted to \$2,356. That cost is expected to be recognized over a weighted average period of 2.5 years. The total fair value of shares vested during fiscal 2008, 2007 and 2006 was \$3,190, \$2,116 and \$2,388, respectively.



(In thousands, except per share amounts)

### Restricted Stock

Restricted stock award recipients are entitled to receive dividends on, and have voting rights with respect to their respective shares, but are restricted from selling or transferring the shares prior to vesting. Restricted stock awards vest over a period of one to four years. The aggregate fair market value of the restricted stock is considered unearned compensation at the time of grant and is amortized over the vesting period.

At June 30, 2008 and 2007, the Company had 14 and 43 shares of unvested restricted stock outstanding at weighted average prices of \$23.94 and \$13.77, respectively. During fiscal 2008, 11 shares of restricted stock were granted at an average grant price of \$24.31 per share. Unamortized compensation related to unvested restricted stock awards aggregated \$375 and \$349 at June 30, 2008 and 2007, respectively. The unamortized compensation cost related to restricted stock is expected to be amortized over the remaining vesting period of 1.2 years.

### Long-Term Performance Grants

The Executive Organization and Compensation Committee also makes annual awards of three-year performance grants to key officers. A target payout is established at the beginning of each three-year performance period. The actual payout at the end of the period is calculated based upon the Company's achievement of sales growth, return on sales, and total shareholder return targets. Total shareholder return is calculated based upon the increase in the Company's common stock price, including dividend reinvestment, over the performance period as compared to the Company's peers, as defined in the plan. Payouts are made in cash, common stock, or a combination thereof, as determined at the end of the performance period.

During fiscal 2008, 2007 and 2006, the Company recorded \$493, \$549 and \$540, respectively, of compensation expense for achievement relative to the total shareholder return-based goals of the Company's performance grants. At June 30, 2008, and 2007, the Company had accrued \$762 and \$1,174, respectively, for compensation relative to these goals. At June 30, 2008, potential compensation expense related to the outstanding performance grants was \$2,274. This compensation expense is expected to be recognized over the remaining performance period of 1.6 years.

### Shareholders' Rights

The Company previously had a shareholder rights plan which expired in January 2008. No rights were issued under the plan.

### Treasury Shares

At June 30, 2008, 596 shares of the Company's common stock held as treasury shares were restricted as collateral under escrow arrangements relating to change in control and director and officer indemnification agreements.

## NOTE 9: BENEFIT PLANS

### Retirement Savings Plan

Substantially all U.S. associates participate in the Applied Industrial Technologies, Inc. Retirement Savings Plan. The Company makes a discretionary profit-sharing contribution to the Retirement Savings Plan generally based upon a percentage of the Company's U.S. income before income taxes and before the amount of the contribution (5% for fiscal 2008, 2007 and 2006). The Company also partially matches 401(k) contributions by participants, who may elect to contribute up to 50% of their compensation, subject to Internal Revenue Code maximums. Until July 1, 2006, matching contributions were made with the Company's common stock and were determined quarterly using rates based on achieving pre-determined quarterly earnings per share levels (ranging from 25% to 100% of the first 6% of compensation contributed to the plan). Effective July 1, 2006, the matching contribution is made in cash which is then used by the administrator to purchase Company stock in the open market. Effective July 1, 2007, the match is based on achieving pre-determined quarterly net income levels and continues to be made in cash which is then used to purchase Company stock in the open market.

The Company's expense for contributions to the above plan was \$12,442, \$11,548 and \$11,365 during fiscal 2008, 2007 and 2006, respectively.

### Deferred Compensation Plans

The Company has deferred compensation plans that enable certain associates of the Company to defer receipt of a portion of their compensation and non-employee directors to defer receipt of director fees. The Company funds these deferred compensation liabilities by making contributions to rabbi trusts. Contributions consist of Company common stock and investments in money market and mutual funds.

### Postemployment Benefit Plans

The Company provides the following postemployment benefits which, except for the Qualified Defined Benefit Retirement Plan, are unfunded:

#### *Supplemental Executive Retirement Benefits Plan*

The Company has a non-qualified pension plan to provide supplemental retirement benefits to certain officers. Benefits are payable at retirement based upon a percentage of the participant's compensation.

#### *Qualified Defined Benefit Retirement Plan*

The Company has a qualified defined benefit retirement plan that provides benefits to certain hourly associates at retirement. The benefits are based on length of service and date of retirement. These associates do not participate in the Retirement Savings Plan.

#### *Salary Continuation Benefits*

The Company has agreements with certain retirees to pay monthly retirement benefits for a period not in excess of 15 years. The discount rate used in determining the benefit obligation was 6.0% at June 30, 2008 and 2007.

#### *Retiree Health Care Benefits*

The Company provides health care benefits to eligible retired associates who pay the Company a specified monthly premium. Premium payments are based upon current insurance rates for the type of coverage provided and are adjusted annually. Certain monthly health care premium payments are partially

subsidized by the Company. Additionally, in conjunction with a fiscal 1998 acquisition, the Company assumed the obligation for a post-retirement medical benefit plan which provides health care benefits to eligible retired associates at no cost to the individual.

On June 30, 2007, the Company prospectively adopted SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of SFAS 87, 88, 106, and 132 (R)" ("SFAS 158"). This statement requires a company to recognize the funded status of retirement and other postretirement benefit plans as an asset or liability in its balance sheet, measured as the difference between plan assets at fair value and the benefit obligation. It also requires the Company to recognize changes in that funded status, other than those recognized as components of net periodic benefit cost, in the year in which the changes occur through accumulated other comprehensive income (loss), net of tax. Adoption of SFAS 158 did not change amounts recognized in the consolidated income statement as net periodic benefit cost, nor did it affect retirement plan funding requirements. The Company uses a June 30 measurement date for all plans.

The changes in benefit obligations, plan assets and funded status for the postemployment plans described above were as follows:

	Pension Benefits		Retiree Health Care Benefits	
	2008	2007	2008	2007
<b>Change in benefit obligation:</b>				
Benefit obligation at beginning of the year	\$ 42,210	\$ 35,071	\$ 4,173	\$ 3,981
Service cost	2,090	1,685	49	56
Interest cost	2,413	2,032	271	222
Plan participants' contributions			31	28
Benefits paid	(4,655)	(855)	(207)	(223)
Amendments	249	1,404	419	141
Actuarial loss (gain) during year	269	2,873	(812)	(32)
Benefit obligation at June 30	\$ 42,576	\$ 42,210	\$ 3,924	\$ 4,173
<b>Change in plan assets:</b>				
Fair value of plan assets at beginning of year	\$ 5,893	\$ 5,254		
Actual (loss) gain on plan assets	(249)	731		
Employer contributions	4,541	763	\$ 176	\$ 194
Plan participants' contributions			31	29
Benefits paid	(4,655)	(855)	(207)	(223)
Fair value of plan assets at June 30	\$ 5,530	\$ 5,893	\$ 0	\$ 0
<b>Funded status at June 30</b>	<b>\$ (37,046)</b>	<b>\$ (36,317)</b>	<b>\$ (3,924)</b>	<b>\$ (4,173)</b>
<b>Amounts recognized in the consolidated balance sheets consist of:</b>				
Prepaid benefit cost		\$ 873		
Current liabilities	\$ (2,953)	(4,541)	\$ (270)	\$ (270)
Noncurrent liabilities	(34,093)	(32,649)	(3,654)	(3,903)
Net amount recognized	\$ (37,046)	\$ (36,317)	\$ (3,924)	\$ (4,173)
<b>Amounts recognized in accumulated other comprehensive loss (income) consist of:</b>				
Net actuarial loss (gain)	\$ 12,834	\$ 12,813	\$ (1,465)	\$ (760)
Prior service cost	4,330	4,716	490	190
Total amounts recognized in accumulated other comprehensive loss (income)	\$ 17,164	\$ 17,529	\$ (975)	\$ (570)

The discount rate is used to determine the present value of future payments. In general, the Company's liability increases as the discount rate decreases and decreases as the discount rate increases. The Company selects a discount rate using the Citigroup Pension Liability Index over the estimated duration of the plans.

The weighted-average actuarial assumptions at June 30 used to determine benefit obligations for the plans were as follows:

	Pension Benefits		Retiree Health Care Benefits	
	2008	2007	2008	2007
Discount rate	6.0%	6.0%	6.0%	6.0%
Expected return on plan assets	8.0%	8.0%	N/A	N/A
Rate of compensation increase	5.5%	5.5%	N/A	N/A

The following table provides information for pension plans with an accumulated benefit obligation and projected benefit obligation in excess of plan assets:

	Pension Benefits	
	2008	2007
Projected benefit obligations	\$ 42,576	\$ 37,191
Accumulated benefit obligations	35,385	28,963

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

The net periodic pension costs are as follows:

	2008	Pension Benefits	
		2007	2006
Service cost	\$ 2,090	\$ 1,685	\$ 1,450
Interest cost	2,413	2,032	1,601
Expected return on plan assets	(466)	(415)	(381)
Recognized net actuarial loss	962	804	784
Amortization of prior service cost	635	658	627
Net periodic pension cost	\$ 5,634	\$ 4,764	\$ 4,081

	2008	Retiree Health Care Benefits	
		2007	2006
Service cost	\$ 49	\$ 56	\$ 55
Interest cost	271	222	253
Recognized net actuarial (gain) loss	(107)	(109)	28
Amortization of prior service cost	119	49	49
Net periodic pension cost	\$ 332	\$ 218	\$ 385

The estimated net loss and prior service cost for the pension plans that will be amortized from accumulated other comprehensive income (loss) into net periodic benefit cost over the next fiscal year are \$917 and \$688, respectively. The estimated net gain and prior service cost for the retiree health care benefits that will be amortized from accumulated other comprehensive income (loss) into net periodic benefit cost over the next fiscal year are (\$126) and \$119, respectively.

The assumed health care cost trend rates used in measuring the accumulated benefit obligation for post-retirement benefits other than pensions were 8% and 10% as of June 30, 2008 and June 30, 2007, respectively, decreasing to 5% by 2015 and 2012, respectively. A one-percentage point change in the assumed health care cost trend rates would have had the following effects as of June 30, 2008 and for the year then ended:

	One-Percentage Point Increase	One-Percentage Point Decrease
Effect on total service and interest cost components of periodic expense	\$ 53	\$ (43)
Effect on post-retirement benefit obligation	541	(449)

Applied Industrial Technologies, Inc.'s Qualified Defined Benefit Retirement Plan weighted average asset allocation and target allocation are as follows:

Asset Category:	Target Allocation	Percentage of Pension Plan Assets at Fiscal Year End	
	2009	2008	2007
Equity securities	40-70%	57%	61%
Debt securities	20-50%	39%	33%
Other	0-20%	4%	6%
Total	100%	100%	100%

Equity securities do not include any Applied Industrial Technologies, Inc. common stock.

The Company has established an investment policy and regularly monitors the performance of the assets of the trust maintained in conjunction with the Qualified Defined Benefit Retirement Plan. The strategy implemented by the trustee of the Qualified Defined Benefit Retirement Plan is to achieve long-term objectives and invest the pension assets in accordance with ERISA and fiduciary standards. The long-term primary objectives are to provide for a reasonable amount of long-term capital, without undue exposure to risk; to protect the Qualified Defined Benefit Retirement Plan assets from erosion of purchasing power; and to provide investment results that meet or exceed the actuarially assumed long-term rate of return. The expected long-term rate of return on assets assumption was developed by considering the historical returns and the future expectations for returns of each asset class as well as the target asset allocation of the pension portfolio.

### Cash Flows

#### Employer Contributions

The Company expects to contribute \$3,000 to its pension benefit plans and \$200 to its retiree health care benefit plans in 2009.



### Estimated Future Benefit Payments

The Company expects to make the following benefit payments, which reflect expected future service:

During Fiscal Years	Pension Benefits	Retiree Health Care Benefits
2009	\$ 3,100	\$ 200
2010	1,800	300
2011	6,100	300
2012	4,100	300
2013	4,300	300
2014 through 2018	14,600	1,200

### NOTE 10: LEASES

The Company leases its corporate headquarters facility along with many service center and distribution center facilities, vehicles and equipment under non-cancelable lease agreements accounted for as operating leases. The minimum annual rental commitments under non-cancelable operating leases as of June 30, 2008 are as follows:

During Fiscal Years	
2009	\$ 20,700
2010	14,100
2011	10,200
2012	8,000
2013	5,000
Thereafter	10,100
Total minimum lease payments	\$ 68,100

Rental expenses incurred for operating leases, principally from leases for real property, vehicles and computer equipment were \$29,000 in fiscal 2008, \$28,300 in 2007 and \$26,700 in 2006.

### NOTE 11: SEGMENT INFORMATION

The Company has identified two reportable segments: Service Center Based Distribution and Fluid Power Businesses. The Service Center Based Distribution segment provides customers with solutions to their maintenance, repair and original equipment manufacturing needs through the distribution of industrial products including bearings, power transmission components, fluid power components, industrial rubber products, linear motion products, safety products, general maintenance and a variety of mill supply products. The Fluid Power Businesses segment distributes fluid power components and operates shops that assemble fluid power systems and components, performs equipment repair, and offers technical advice to customers.

The accounting policies of the Company's reportable segments are the same as those described in Note 1. Sales between the Service Center Based Distribution segment and the Fluid Power Businesses segment have been eliminated.

Segment Financial Information:

	Service Center Based Distribution	Fluid Power Businesses	Total
<b>Year Ended June 30, 2008</b>			
Net sales	\$ 1,865,663	\$ 223,793	\$ 2,089,456
Operating income	124,271	17,320	141,591
Assets used in the business	712,546	86,225	798,771
Depreciation	11,441	1,335	12,776
Capital expenditures	7,550	860	8,410
<b>Year Ended June 30, 2007</b>			
Net sales	\$ 1,806,284	\$ 207,825	\$ 2,014,109
Operating income	122,684	14,427	137,111
Assets used in the business	715,864	61,505	777,369
Depreciation	12,166	1,323	13,489
Capital expenditures	10,074	1,118	11,192
<b>Year Ended June 30, 2006</b>			
Net sales	\$ 1,725,392	\$ 175,388	\$ 1,900,780
Operating income	111,774	11,849	123,623
Assets used in the business	670,619	60,052	730,671
Depreciation	12,019	1,109	13,128
Capital expenditures	10,310	747	11,057

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

A reconciliation of operating income for reportable segments to the consolidated income before income taxes is as follows:

Year Ended June 30,	2008	2007	2006
Operating income for reportable segments	\$ 141,591	\$ 137,111	\$ 123,623
Adjustments for:			
Amortization expense of intangibles	1,663	1,045	732
Corporate and other (income) expense, net (a)	(12,896)	1,055	7,299
Total operating income	152,824	135,011	115,592
Interest expense, net	882	2,360	3,210
Other expense (income), net	227	(1,179)	(717)
Income before income taxes	\$ 151,715	\$ 133,830	\$ 113,099

(a) The change in corporate and other (income) expense, net is due to various changes in the levels and amounts of expenses being allocated to the segments. The expenses being allocated include miscellaneous corporate charges for working capital, logistics support and other items.

Net sales by product category are as follows:

Year Ended June 30,	2008	2007	2006
Industrial	\$ 1,670,464	\$ 1,614,515	\$ 1,554,589
Fluid power (b)	418,992	399,594	346,191
Net sales	\$ 2,089,456	\$ 2,014,109	\$ 1,900,780

(b) The fluid power product category includes sales of hydraulic, pneumatic, lubrication and filtration components and systems, and repair services through the Company's service centers as well as the fluid power businesses.

Net sales are presented in the geographic area in which the Company's customers are located. Information by geographic area is as follows:

Year Ended June 30,	2008	2007	2006
Net Sales:			
United States	\$ 1,839,410	\$ 1,778,993	\$ 1,686,066
Canada	222,121	211,446	194,594
Mexico	27,925	23,670	20,120
Total	\$ 2,089,456	\$ 2,014,109	\$ 1,900,780
Long-Lived Assets:			
United States	\$ 107,384	\$ 111,357	
Canada	19,455	19,440	
Mexico	22,007	3,253	
Total	\$ 148,846	\$ 134,050	

Long-lived assets are comprised of property, goodwill and other intangible assets.

### NOTE 12: COMMITMENTS AND CONTINGENCIES

In connection with the construction and lease of its corporate headquarters facility, the Company has guaranteed repayment of a total of \$5,678 of taxable development revenue bonds issued by Cuyahoga County and the Cleveland-Cuyahoga County Port Authority. These bonds were issued with a 20-year term and are scheduled to mature in March 2016. Any default, as defined in the guarantee agreements, would obligate the Company for the full amount of the outstanding bonds through maturity. Due to the nature of the guarantee, the Company has not recorded any liability on the consolidated financial statements. In the event of a default and subsequent payout under any or all guarantees, the Company maintains the right to pursue all legal options available to mitigate its exposure.

The Company is a party to various pending judicial and administrative proceedings. Based on circumstances currently known, the Company believes the likelihood is remote that the ultimate resolution of any of these matters will have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position, results of operations, or cash flows.

**NOTE 13: OTHER EXPENSE (INCOME), NET**

Other expense (income), net consists of the following:

Year Ended June 30,	2008	2007	2006
Unrealized loss on cross-currency swap	\$ 277	\$ 243	\$ 595
Unrealized loss (gain) on deferred compensation trusts	327	(1,397)	(869)
Other	(377)	(25)	(443)
Total other expense (income), net	\$ 227	\$ (1,179)	\$ (717)

The Company is the owner and beneficiary under life insurance policies acquired in conjunction with a fiscal 1998 acquisition, with benefits in force of \$14,000 and a net cash surrender value of \$2,900 at June 30, 2008.

**NOTE 14: SUBSEQUENT EVENT**

On July 14, 2008, the Company entered into an agreement to acquire certain assets of Fluid Power Resource, LLC, including seven fluid power businesses for cash consideration of \$169.0 million. The Company intends to fund the acquisition by drawing down its existing revolving credit facility and from its available cash. These businesses employ 455 people and for the year ended December 31, 2007 had sales of approximately \$244.0 million. Results of operations acquired will be included in the Company's results of operations from the date of closing.





To the Board of Directors and Shareholders of Applied Industrial Technologies, Inc.  
Cleveland, Ohio

We have audited the accompanying consolidated balance sheets of Applied Industrial Technologies, Inc. and subsidiaries (the "Company") as of June 30, 2008 and 2007, and the related statements of consolidated income, shareholders' equity, and cash flows for each of the three years in the period ended June 30, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at June 30, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended June 30, 2008, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 7 to the consolidated financial statements, effective July 1, 2007, the Company adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. Also, as discussed in Note 9 to the consolidated financial statements, the Company adopted SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, in 2007.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of June 30, 2008, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated August 15, 2008 expressed an unqualified opinion on the Company's internal control over financial reporting.

*Deloitte & Touche LLP*

Cleveland, Ohio  
August 15, 2008

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Management of Applied Industrial Technologies, Inc. is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of, the Chairman & Chief Executive Officer and the Vice President – Chief Financial Officer & Treasurer, and effected by the Company's Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of consolidated financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

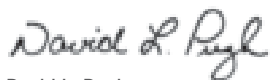
The Company's internal control over financial reporting includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of consolidated financial statements in accordance with accounting principles generally accepted in the United States of America and that receipts and expenditures of the Company are being made only in accordance with authorizations of the Company's Management and Board of Directors; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the consolidated financial statements.

Because of inherent limitations, internal control over financial reporting can provide only reasonable, not absolute, assurance with respect to the preparation and presentation of the consolidated financial statements and may not prevent or detect misstatements. Further, because of changes in conditions, effectiveness of internal control over financial reporting may vary over time.


Management conducted an evaluation of the effectiveness of the Company's internal control over financial reporting as of June 30, 2008. This evaluation was based on the criteria set forth in the framework *Internal Control—Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, Management determined that the Company's internal control over financial reporting was effective as of June 30, 2008.

The effectiveness of the Company's internal control over financial reporting has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included herein.

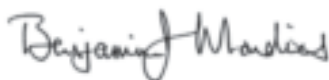
August 15, 2008



David L. Pugh  
Chairman & Chief Executive Officer



Mark O. Eisele  
Vice President – Chief Financial Officer & Treasurer



Benjamin J. Mondics  
President & Chief Operating Officer



Daniel T. Brezovec  
Corporate Controller



To the Board of Directors and Shareholders of Applied Industrial Technologies, Inc.  
Cleveland, Ohio

We have audited the internal control over financial reporting of Applied Industrial Technologies, Inc. and subsidiaries (the "Company") as of June 30, 2008, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 30, 2008, based on the criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet and the related statements of consolidated income, shareholders' equity and cash flows as of and for the year ended June 30, 2008 of the Company and our report dated August 15, 2008 expressed an unqualified opinion on those consolidated financial statements and included an explanatory paragraph regarding the Company's adoption of a new accounting standard.

*Deloitte : Touche LLP*

Cleveland, Ohio  
August 15, 2008

## QUARTERLY OPERATING RESULTS AND MARKET DATA

(In thousands, except per share amounts)

	Net Sales	Gross Profit	Operating Income	Net Income	Per Common Share (B)			
					Net Income - Diluted	Cash Dividend	Price Range	
							High	Low
<b>2008 (A)</b>								
First Quarter	\$ 518,547	\$ 142,056	\$ 39,216	\$ 24,457	\$ 0.56	\$ 0.15	\$ 33.26	\$ 22.90
Second Quarter	511,008	139,491	37,268	22,967	0.52	0.15	35.68	28.01
Third Quarter	530,156	144,500	37,685	23,595	0.55	0.15	30.68	22.05
Fourth Quarter	529,745	143,236	38,655	24,437	0.57	0.15	32.20	23.81
	<b>\$ 2,089,456</b>	<b>\$ 569,283</b>	<b>\$ 152,824</b>	<b>\$ 95,456</b>	<b>\$ 2.19</b>	<b>\$ 0.60</b>		
<b>2007 (A)</b>								
First Quarter	\$ 492,590	\$ 135,134	\$ 33,377	\$ 21,117	\$ 0.47	\$ 0.12	\$ 25.50	\$ 20.75
Second Quarter	472,365	130,151	28,929	18,568	0.42	0.12	30.00	23.61
Third Quarter	521,129	140,572	34,105	21,697	0.49	0.12	26.95	22.72
Fourth Quarter	528,025	142,195	38,600	24,640	0.56	0.12	30.73	24.26
	<b>\$ 2,014,109</b>	<b>\$ 548,052</b>	<b>\$ 135,011</b>	<b>\$ 86,022</b>	<b>\$ 1.93</b>	<b>\$ 0.48</b>		
<b>2006 (A)</b>								
First Quarter	\$ 443,205	\$ 122,304	\$ 27,802	\$ 16,850	\$ 0.36	\$ 0.08	\$ 25.03	\$ 21.33
Second Quarter	456,180	121,397	25,214	15,294	0.33	0.10	24.54	20.41
Third Quarter	497,198	136,815	32,085	19,990	0.43	0.10	31.15	22.50
Fourth Quarter	504,197	133,369	30,491	20,165	0.44	0.12	31.67	21.97
	<b>\$ 1,900,780</b>	<b>\$ 513,885</b>	<b>\$ 115,592</b>	<b>\$ 72,299</b>	<b>\$ 1.57</b>	<b>\$ 0.40</b>		

(A) Cost of sales for interim financial statements are computed using estimated gross profit percentages which are adjusted throughout the year based upon available information. Adjustments to actual cost are primarily made based on periodic physical inventory and the effect of year end inventory quantities on LIFO costs. Reductions in year end inventories during the fiscal years ended June 30, 2008 and 2006 resulted in liquidations of LIFO inventory quantities carried at lower costs prevailing in prior years. The effect of these liquidations for the years ended June 30, 2008 and 2006 increased gross profit by \$626 and \$1,647, net income by \$383 and \$1,013, and diluted net income per share by \$0.01 and \$0.02, respectively. There were no LIFO layer liquidations for fiscal 2007.

(B) On August 11, 2008 there were 6,311 shareholders of record including 4,073 shareholders in the Applied Industrial Technologies, Inc. Retirement Savings Plan. The Company's common stock is listed on the New York Stock Exchange. The closing price on August 11, 2008 was \$30.76 per share.

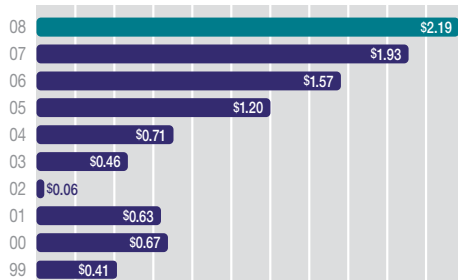


## 10 YEAR SUMMARY

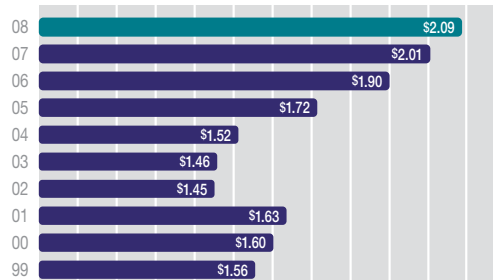
(In thousands, except per share amounts and statistical data)

	2008	2007	2006	2005
<b>Consolidated Operations – Year Ended June 30</b>				
Net sales	\$ 2,089,456	\$ 2,014,109	\$ 1,900,780	\$ 1,717,055
Operating income	152,824	135,011	115,592	87,968
Income before cumulative effect of accounting change	95,456	86,022	72,299	55,339
Net income	95,456	86,022	72,299	55,339
Per share data				
Income before cumulative effect of accounting change				
Basic	2.23	1.97	1.62	1.24
Diluted	2.19	1.93	1.57	1.20
Net income				
Basic	2.23	1.97	1.62	1.24
Diluted	2.19	1.93	1.57	1.20
Cash dividend	0.60	0.48	0.40	0.29
<b>Year-End Position – June 30</b>				
Working capital	\$ 409,186	\$ 365,523	\$ 370,013	\$ 345,806
Long-term debt (including amounts classified as current)	25,000	75,395	76,186	76,977
Total assets	798,771	777,369	730,671	690,170
Shareholders' equity	502,075	450,983	414,822	393,287
<b>Year-End Statistics – June 30</b>				
Current ratio	3.1	2.6	3.0	2.9
Operating facilities	459	445	452	440
Shareholders of record	6,305	6,242	6,192	6,079

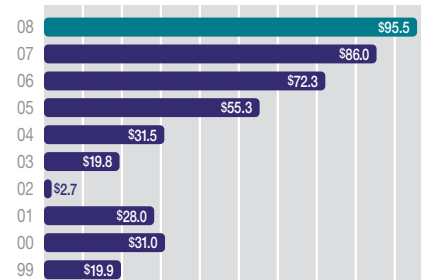
**NET INCOME PER SHARE** (Dollars)



**NET SALES** (Dollars in Billions)

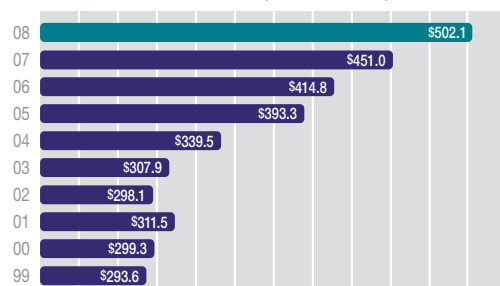


**NET INCOME** (Dollars in Millions)

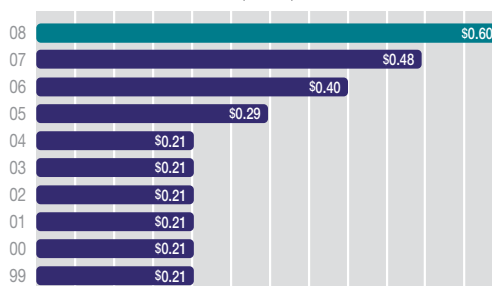


	2004	2003	2002	2001	2000	1999
	\$ 1,517,004	\$ 1,464,367	\$ 1,446,569	\$ 1,625,755	\$ 1,601,084	\$ 1,555,424
	51,448	36,254	30,834	55,001	57,779	42,269
	31,471	19,832	14,755	28,048	31,048	19,933
	31,471	19,832	2,655	28,048	31,048	19,933
	0.73	0.47	0.34	0.64	0.68	0.41
	0.71	0.46	0.34	0.63	0.67	0.41
	0.73	0.47	0.06	0.64	0.68	0.41
	0.71	0.46	0.06	0.63	0.67	0.41
	0.21	0.21	0.21	0.21	0.21	0.21
	\$ 286,022	\$ 259,359	\$ 250,644	\$ 279,001	\$ 255,132	\$ 258,730
	77,767	78,558	83,478	113,494	112,168	126,000
	596,841	553,404	534,566	578,854	594,667	574,349
	339,535	307,856	298,147	311,518	299,331	293,586
	2.9	2.8	2.9	3.2	2.6	3.0
	434	440	449	469	478	444
	6,154	6,157	6,455	6,697	6,548	6,869

#### SHAREHOLDERS' EQUITY (Dollars in Millions)



#### DIVIDENDS PER SHARE (Dollars)





## DIRECTORS

**WILLIAM G. BARES (3, 4)** Age 67  
Former Chairman and Chief Executive Officer  
The Lubrizol Corporation (Specialty Chemical Products)

**THOMAS A. COMMES (1, 3)** Age 66  
Former President and Chief Operating Officer  
The Sherwin-Williams Company (Paints and Coatings)

**PETER A. DORSMAN (2)** Age 53  
Senior Vice President, Global Operations  
NCR Corporation  
(Transaction and Data Warehousing Solutions)

**L. THOMAS HILTZ (2)** Age 62  
Attorney

**EDITH KELLY-GREEN (1)** Age 55  
Former Vice President and Chief Sourcing Officer  
FedEx Express (Express Transportation)

**JOHN F. MEIER (4)** Age 60  
Chairman and Chief Executive Officer  
Libbey Inc. (Tableware Products)

**J. MICHAEL MOORE (1)** Age 65  
President  
Oak Grove Consulting Group, Inc.  
(Management Consulting)  
Former Chairman and Chief Executive Officer  
Invetech Company (Industrial Distributor)

**DAVID L. PUGH (3)** Age 59  
Chairman & Chief Executive Officer  
Applied Industrial Technologies, Inc.

**JERRY SUE THORNTON, Ph.D. (2)** Age 61  
President  
Cuyahoga Community College  
(Two-Year Educational Institution)

**PETER C. WALLACE (2)** Age 54  
President & Chief Executive Officer  
Robbins & Myers, Inc. (Equipment Manufacturer)

**STEPHEN E. YATES (4)** Age 60  
Executive Vice President & Chief Information Officer  
KeyCorp (Financial Services)

### Committees of the Board

- (1) Audit Committee
- (2) Corporate Governance Committee
- (3) Executive Committee
- (4) Executive Organization and Compensation Committee

## OFFICERS

**DAVID L. PUGH** Age 59  
Chairman & Chief Executive Officer

**BENJAMIN J. MONDICS** Age 50  
President & Chief Operating Officer

**THOMAS E. ARMOLD** Age 53  
Vice President – Marketing and Strategic Accounts

**TODD A. BARLETT** Age 53  
Vice President –  
Acquisitions and Global Business Development

**FRED D. BAUER** Age 42  
Vice President – General Counsel & Secretary

**MICHAEL L. COTICCHIA** Age 45  
Vice President – Chief Administrative Officer  
and Government Business

**MARK O. EISELE** Age 51  
Vice President –  
Chief Financial Officer & Treasurer

**JAMES T. HOPPER** Age 64  
Vice President – Chief Information Officer

**JEFFREY A. RAMRAS** Age 53  
Vice President – Supply Chain Management

**RICHARD C. SHAW** Age 59  
Vice President –  
Communications and Learning

**DANIEL T. BREZOVEC** Age 47  
Corporate Controller

**JODY A. CHABOWSKI** Age 48  
Assistant Controller

**ALAN M. KRUPA** Age 52  
Assistant Treasurer

## OTHER KEY MANAGEMENT

**IVAN J. BATISTA** Age 35  
General Director –  
Rafael Benitez Carrillo, Inc. (Puerto Rico)

**ROBERT E. CURLEY** Age 48  
Vice President – Southeast Area

**BARBARA D. EMERY** Age 49  
Vice President – Human Resources

**WARREN E. “BUD” HOFFNER** Age 48  
Vice President, General Manager – Fluid Power

**MARY E. KERPER** Age 57  
Vice President – Operational Excellence

**LONNY D. LAWRENCE** Age 45  
Vice President – Information Technology

**JOHN M. LEYO** Age 57  
Vice President – North Atlantic Area

**SERGIO H. NEVÁREZ** Age 50  
General Director – Applied Mexico

**RONALD A. SOWINSKI** Age 47  
President & Chief Operating Officer –  
Applied Industrial Technologies Ltd. (Canada)

**MARK A. STONEBURNER** Age 44  
Vice President – Midwest Area

**DONN G. VEENHUIS** Age 59  
Vice President – Western Area

**THEODORE L. WOLICKI** Age 54  
Vice President – Central States Area

## SHAREHOLDER INFORMATION

Applied Industrial Technologies, Inc. common stock is listed on the New York Stock Exchange under the symbol AIT. The company is identified in most financial listings as "AppliedIndITch."

**Research on Applied Industrial Technologies is available through:**

### BB&T CAPITAL MARKETS

Holden Lewis, 804/782-8820

### CLEVELAND RESEARCH COMPANY

Adam Uhlman, 216/649-7241

### KEYBANC CAPITAL MARKETS

Jeffrey D. Hammond, 216/443-2825

### MORGAN KEEGAN

Brent D. Rakers, 901/579-4427

### SOLEIL – GREAT LAKES REVIEW

Elliot Schlang, 216/767-1340

### STEPHENS INC.

Matt Duncan, 501/377-3723

### WACHOVIA CAPITAL MARKETS, LLC

Allison Poliniak, 212/214-5062

### SHAREHOLDER INQUIRIES

Requests to transfer Applied Industrial Technologies, Inc. shares and all correspondence regarding address change information, duplicate mailings, missing certificates, failure to receive dividend checks in a timely manner or to participate in the Company's direct stock purchase program should be directed to the Company's transfer agent and registrar:

#### COMPUTERSHARE INVESTOR SERVICES

250 Royall Street  
Mail Stop 1A  
Canton, MA 02021  
800/988-5291

**Investor relations inquiries should be directed to:**

#### MARK O. EISELE

Vice President – Chief Financial Officer & Treasurer  
Applied Industrial Technologies  
1 Applied Plaza  
Cleveland, OH 44115-5014  
Telephone: 216/426-4000, Fax: 216/426-4845

### ANNUAL REPORT ON FORM 10-K

**The Applied Industrial Technologies, Inc. Annual Report on Form 10-K for the fiscal year ended June 30, 2008, including the financial statements and schedules thereto, is available at our web site at [www.applied.com](http://www.applied.com). It is also available without charge upon written request to the Vice President – Chief Financial Officer & Treasurer at the preceding address.**

### REGULATORY CERTIFICATIONS

In fiscal 2008, the Chief Executive Officer (CEO) of Applied Industrial Technologies, Inc. provided to the New York Stock Exchange (NYSE) the annual CEO certification regarding the Company's compliance with NYSE corporate governance listing standards. In addition, the Company's CEO and Chief Financial Officer filed with the Securities and Exchange Commission the required certifications regarding the quality of the Company's public disclosures in its fiscal 2008 reports and the effectiveness of internal control over financial reporting.

### ANNUAL MEETING

The Annual Meeting of Shareholders will be held at 10:00 a.m., Tuesday, October 21, 2008, at the Corporate Headquarters of Applied Industrial Technologies, 1 Applied Plaza, East 36th and Euclid Avenue, Cleveland, Ohio 44115.

## QUARTERLY VOLUME, PRICE AND DIVIDEND INFORMATION

	Shares Traded	Average Daily Volume	Price Range		Cash Dividend
			High	Low	
<b>2008</b>					
First Quarter	21,416,800	339,900	\$ 33.26	\$ 22.90	\$ 0.15
Second Quarter	19,630,600	306,700	35.68	28.01	0.15
Third Quarter	26,431,600	433,300	30.68	22.05	0.15
Fourth Quarter	26,215,300	409,600	32.20	23.81	0.15
<b>2007</b>					
First Quarter	20,528,900	325,900	\$ 25.50	\$ 20.75	\$ 0.12
Second Quarter	16,447,500	261,100	30.00	23.61	0.12
Third Quarter	17,787,400	291,600	26.95	22.72	0.12
Fourth Quarter	18,389,300	291,900	30.73	24.26	0.12
<b>2006</b>					
First Quarter	11,773,500	184,000	\$ 25.03	\$ 21.33	\$ 0.08
Second Quarter	17,774,000	282,100	24.54	20.41	0.10
Third Quarter	15,937,300	257,000	31.15	22.50	0.10
Fourth Quarter	26,181,000	415,600	31.67	21.97	0.12





**Applied Industrial Technologies**  
Corporate Headquarters  
1 Applied Plaza  
Cleveland, Ohio, 44115  
216/426-4000  
[www.applied.com](http://www.applied.com)